

# *The New York* Certified Public Accountant



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## TABLE OF CONTENTS

	PAGE
State Society Activities . . . . .	497
Professional Comment . . . . .	501
The Accountant's View on Profit Limitation By WALTER A. STAUB, C.P.A. . . . .	508
Changing Concepts of the Responsibilities of the Accountant By VICTOR H. STEMPE, C.P.A. . . . .	518
Securities and Exchange Commission Release . . . . .	527
Problems of Financial Reporting Under Wartime Conditions . . . . .	530
Authors of Articles . . . . .	543

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THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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WENTWORTH F. GANTT

*Managing Editor*

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*[The matter contained in this publication, unless otherwise stated, will not be binding upon the Society; and it should be understood that any opinions expressed in articles published herein are the opinions of the authors of the articles, respectively, and are not promulgated by the Society.]*

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June

# STATE SOCIETY ACTIVITIES

## Calendar of Events

June 2—Ninth Annual Outing—Westchester Country Club, Rye, New York.

June 4—7:30 P.M.—Special Technical Meeting. Subject: **Contingent Liabilities and Commitments**. Location: Engineering Auditorium, 29 West 39th Street, New York City.

June 15—7:30 P.M.—Special Society meeting. Location: Waldorf-Astoria Hotel, Lexington Avenue at 49th Street, New York City. Subject: **Production for Victory**.

June 18—Regular Meeting of the Board of Directors.

June 26-28—Ninth Regional Conference, Hotel Saranac, Saranac Lake, New York.

## Ninth Regional Conference

The time is drawing near for the Ninth Annual Regional Conference of the Society, which will be held this year at Hotel Saranac, Saranac Lake, New York. The dates will be June 26-28, and the Committee in charge of the arrangements is pleased to announce that an attractive program is being prepared. The program is being planned to assist each member to handle better the problems resulting from the present wartime conditions. Subjects will include: Taxation, Accounting Problems under War Production Board requirements—such as the Production Requirements Plan, Accounting Problems under Office of Price Administration requirements—problems in connection with maximum amount of interim work possible, financial statements and renegotiation of war contracts. Golf, tennis,

and other recreational activities will be provided.

The membership will be advised of the program details at a later date. However, all those who plan to attend this Conference should make their reservations with the office of the Society, 15 East 41st Street, New York City.

## Committee on Nominations

The following is the personnel of the 1942 Committee on Nominations:

Thomas Conroy  
Franklin C. Ellis  
James F. Hughes  
Albert Krauter  
Winfield McKeon  
Ira A. Schur  
Isidor Sack

The above members were elected at the May 11th Society meeting, and two others will be selected by the Board of Directors at its meeting in October.

## Ninth Annual Outing

On June 2, 1942, the Society's Annual Outing and Tournament was held at the Westchester Country Club, Rye, New York. In view of the threatening weather, the attendance was exceptionally good. The tennis tournament was postponed because of the weather and will be held on June 12th at the West Side Tennis Club, Forest Hills, New York. The results of this tournament will be published in the July bulletin.

The following members were given awards:

## GOLF

The Walter A. Staub Trophy for the best (low gross) score was won by R. A. Henry with a 79, while Freeman Davis was the winner of

## The New York Certified Public Accountant

the Lafrentz Trophy for low net with a score of 76. Winners in each of the three low net groups, all of whom received prizes, were as follows, together with the net scores as turned in:

### CLASS A

T. Graven.....	75
G. E. Bennett .....	77
C. H. Dyson .....	78

### CLASS B

Freeman Davis .....	76
J. S. Frampton .....	79
M. F. Locke.....	80

### CLASS C

Walter N. Dean.....	77
H. E. Van Benshoten ..	79
Wm. Henry Peterson...	84

### DOOR PRIZES

The door prizes given at dinner were won by J. Arthur Marvin, A. S. Fedde, and James Malloy.

### Wartime Problems Releases

Wartime Problems Releases No. 8 and No. 9 were sent to the membership by the Society's Special Committee on Wartime Problems during the month of May.

#### Release No. 8

Release No. 8 was a report from the Society's Committee on Accountants' Office Procedure as to the effect of present and future priorities and scarcities upon accountants' office supplies. This report showed that continued manufacture of erasers is problematical because of the rubber shortages and restrictions, and even now rubber bands are already practically impossible to obtain. While there is no shortage of pencils and none appears imminent, they will not be manufactured in the future with erasers attached. Clips and staples will shortly become unavailable to anyone not having a priority rating of at least A-10-A, and accounting firms will probably not be able to obtain such a high rating. Type-

writer ribbons are, and in all probability will remain, accessible, the only requirement at this time being that a spool and container must be returned for each ribbon purchased. The paper situation now is that 24-lb. paper will not be manufactured, lighter weights are available but will be condensed as to color and sizes, the cut in the chlorine content in the pulp has reduced the whiteness and brightness of paper, priorities should not affect rag papers of over 25% rag content to any extent, deliveries are returning to normal, and prices have become steadier.

Work paper and columnar paper may be difficult to procure immediately because there are large government orders for this on hand resulting in a lag in delivery dates. Typewriters and other office machines may present a serious problem to accounting offices which are expanding because at the present time the accounting profession is not entitled to any blanket priority rating in obtaining equipment or supplies.

Because of the above-named shortages, the Committee on Accountants' Office Procedure urges each member of the Society to review his office procedures and forms, as well as those of his clients, with a view towards reducing the use of supplies.

#### Release No. 9

Release No. 9 was a report of part of the proceedings of the Priorities Round Table on Accounting Procedure in Connection with the Production Requirements Plan held on April 28, 1942. Mr. Herbert L. Carpenter, Director of the Commerce and Industry Association and Chairman of its Special Committee on Priorities, presided at the meeting, and Mr. Sydney Hogerton, Priorities District Manager, Bureau of Field Operations, War Production Board, Mr. William E. Arnstein, Production Requirements Plan Branch, Division of Priorities, Washington, D. C., and Mr.



William R. Donaldson, Chairman of the Society's Special Committee on Wartime Problems, all took part in the discussion.

Mr. Carpenter indicated that the Director of Industry Operations has announced that the War Production Board will soon discontinue granting preference rates on individual applications and material, and also that most of the Blanket Preference Rating Orders will be discontinued so that eventually all American industries requesting priority assistance will be expected to apply under the Production Requirements Plan for the quarter beginning July 1st. This is for the purpose of controlling the flow of materials and insuring their use for War production and essential civilian needs.

Mr. Hogerton stated that the Bureau of Field Operations will be glad to assist manufacturers in the preparation of their applications if they will call at the Bureau's office in the Chanin Building, New York City, and they shall expect that every manufacturer before submitting his application to Washington will bring it to their office where it will be checked in various ways to insure conformity with the regulations. He pointed out that the War Production Board is determined to avoid the building up of excessive inventories and also to prevent the use of critical materials for purposes other than those for which they were approved. They hope that the adequate dissemination of information regarding the regulations will make it possible for industry in general to avoid non-compliance and the embarrassment and penalties that might ensue. He said that public accountants can perform a valuable service for their clients in this respect.

Mr. Arnstein then fully described the pink forms which are used for priority applications, and urged that a letter giving any details which you think would help your client's case should accompany each application,

as the Priorities Division spends just as much time studying the letter as it does the application.

Mr. Donaldson closed the discussion by pointing out that members of the accounting profession can do more than any other to assist the government in launching and carrying through this plan on a smooth-running basis. He said accountants have the opportunity to be of great service to their clients in telling them of the Plan and in aiding them to get their procedures set up to meet it, and it also offers them the chance to expand their services to these clients.

### Chapter Elections

At recent annual meetings, the four Chapters of the Society at Albany, Buffalo, Rochester, and Syracuse elected the following officers for the coming year:

#### Albany Chapter

Charles L. Marvin.....*President*  
John B. Cantwell.....*Vice President*  
Alice M. Blanchard.....*Secretary*  
William Boochever.....*Treasurer*

#### Buffalo Chapter

Harry Care.....*President*  
Ralph H. Franclemont.....*Vice President*  
Joseph Brock.....*Secretary*  
Maynard W. Lockwood.....*Treasurer*

#### Rochester Chapter

Oscar L. Niles.....*President*  
Edmund A. Randall.....*Vice President*  
Frederick W. Rapp.....*Secretary*  
Edwin O. Steinmann.....*Treasurer*

#### Syracuse Chapter

Harry D. Anderson.....*President*  
Howard P. Nicholson.....*Vice President*  
Erwin F. Liegel.....*Secretary*  
Samuel Singer.....*Treasurer*

### Passed October, 1942, Examination

Notice has just been received that Jack Schwaeber of 45 Kew Gardens Road, Kew Gardens, N. Y. was among those who passed the October, 1941, C.P.A. exam. Mr. Schwaeber's name was not included in the list published in the May bulletin.

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**Homer St. Clair Pace**



In the death, on May 22, 1942, of Homer St. Clair Pace, the Society and the accountancy profession suffered the loss of a prominent and beloved member.

Mr. Pace was admitted to membership in the Society in 1908 and since that date has served on many of its committees, both before and after his term as president during 1924-1926. It was during his administration as president that the Society secured a permanent office and staff.

He was widely known as founder and president of Pace Institute, and co-founder in 1906 with his brother of the firm Pace & Pace which conducted schools featuring accountancy and business law in a number of cities. He was the author of many

books on accounting and financial subjects and had traveled extensively throughout the world. He is survived by his widow, a daughter, two sons, and two grandchildren.

Mr. Pace's service to the Society has won him a permanent place in its history. His name and his rare personality have, for over thirty years, been inseparably linked with business education and the accounting profession of our State. Always busy, he found time to respond repeatedly to demands to serve the Society and the profession.

His genial, tolerant, sincere and enduring personality won for him a host of friends. His counsel was freely sought and generously given. Through his service and his life, Homer St. Clair Pace has exerted a lasting influence upon the profession of his choice, and he will always be held in memory with highest regard by the members of the New York State Society of Certified Public Accountants.

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**James E. Nugent**

James E. Nugent, a valued and esteemed member of the Society since 1926, died on May 12, 1942, after a month's illness. He had served for many years as a member of the Grievance Committee of the State of New York.

In his death, this Society, as well as the accountancy profession at large has sustained the loss of an able and loyal member whose record of devotion to the practice of his profession has contributed much to the development of accountancy and has exerted an influence which will long survive him.

Mr. Nugent is survived by a son.

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## PROFESSIONAL COMMENT

### Bill Advancing State Franchise Tax Vetoed by Governor

Governor Lehman vetoed the so-called "Moffat Bill" passed by the Legislature during the last session. This bill was opposed by the Society and other business groups on the basis of the provision which would advance the date from May 15th to March 15th of filing and paying the New York State Franchise Tax. The Governor's veto message follows:

"STATE OF NEW YORK  
EXECUTIVE CHAMBER  
ALBANY

May 22, 1942

"MEMORANDUM filed with Assembly Bill, Introductory Number 26, Senate Reprint Number 2540, entitled:

'AN ACT to amend the state finance law, the education law, the tax law, and the civil service law, in relation to the fiscal year of the state, the payment of apportionments of school moneys, the time of payment of the taxes on personal incomes, of the franchise taxes on savings banks, business corporations, state banks, trust companies and financial corporations and the taxes on national banking institutions, and the time of eligibility of annual increments of state employees.'

#### NOT APPROVED:

"The main purpose of this bill is to change the fiscal year of the State from July 1 to April 1. It also makes provision by which income tax payments can be made in four equal installments instead of three installments, as at present.

"The bill is the result of a great

deal of study and effort on the part of the Chairman of the Assembly Ways and Means Committee. It has also been very carefully studied and considered by me and my financial advisers.

"When a change in the fiscal year was first discussed, it was believed by the Chairman of the Assembly Ways and Means Committee that the change could be made by resorting to only two more or less minor fiscal adjustments. On further study, it developed, however, that in order to make the change in date, not two adjustments but six would be required, some of which are of great importance.

"I, therefore, announced that before coming to a decision with regard to the bill, I desired to study further the question whether the advantages to be gained from the change, either in budgetary procedure or in benefit to taxpayers, outweighed the disadvantages to those affected adversely by these adjustments.

"After very careful study, I have come to the conclusion that—at least at the present time—the disadvantages substantially outweigh the advantages.

"From a budgetary standpoint, it is at best a close question whether it is better to have the fiscal year start on April 1 than on July 1. Much can be said on either side. Certainly, the advantage from the budgetary standpoint of having the fiscal year start on April 1 rather than on July 1 is by no means clear. It is, however, clear that the several changes proposed in the bill would create substantial dislocations, both from an administrative standpoint and from the standpoint of the taxpayers. For instance, the burden on those paying the corporation tax

would, I believe, be immeasurably increased, since it would be greatly difficult to complete the tax returns by March 15, and the new proposed date would be coincident with the payment of very heavy Federal taxes. The bill, too, would obviously impose greatly added burdens on the administrative departments of the State Government, since it would consolidate peak loads in the collection of taxes which have in the past been deliberately distributed over a considerable period for the purpose of using the same personnel in the collection of several different taxes.

"It is clear to me that this is no time to place added administrative burdens either on governmental departments or on industry. Both already are under tremendous pressure because of increased demands and reduced personnel. Their work should, if possible, be simplified rather than made more complicated.

"Under the circumstances, I feel that at least for the present the change in the fiscal year provided for in this bill should not be adopted.

"The second purpose of the bill is to make possible the payment of personal income taxes in four equal installments rather than in three installments, as at present. This part of the bill follows the recommendation which I made to the Legislature. A separate bill to effectuate the change was introduced into the Legislature. I sincerely wish that the proposal had been enacted as a separate bill rather than as a part of this bill. In that event, I would have been glad to approve it. Unfortunately, however, I cannot approve that part of the bill without approving the bill as a whole.

"I beg to point out that a bill to effectuate this one change in installment payments may be introduced and passed in the early days of the next session, thus making it effective for next year's tax payments. In this connection, however, it is interesting to note that relatively

few taxpayers availed themselves this year of the right to pay in installments. Although the taxpayers now have the right to pay their income tax in three installments, only 11% of the taxpayers availed themselves of this privilege. All the other taxpayers paid their taxes in full at one time. This is undoubtedly due to the great reduction which we have made this year in the personal income tax through the elimination of the 1% emergency tax and the additional cut of 25% in the remaining tax. Those reductions have already cut the income tax load of most of our citizens by about one-half.

"This bill is disapproved.

(Signed) HERBERT H. LEHMAN"

#### **O.P.A. Financial Reporting Program**

*This is the text of an official release by the Office of Price Administration, May 2, 1942, describing new financial reporting forms issued May 10th, on which about 25,000 corporations will be required to submit financial data to O.P.A.*

"A general financial reporting program designed to provide basic financial data necessary for studies of price-control problems in many industries where adequate information is not now available was instituted today by Price Administrator Leon Henderson.

"Reporting forms and an instruction book requiring balance-sheet and income-account data are being printed and will be sent May 10th to about 25,000 business corporations, with over \$250,000 assets each, engaged in manufacturing, mining, construction, wholesale trade, retail trade and related fields.

"The initial annual financial report (Form A) and the first interim or quarterly financial report (Form B) of companies using the calendar-year basis must be filed with O.P.A. within 30 days after receipt of the request. If the fiscal year to be covered by the initial annual report is other

than the calendar year, the report must be filed within three months of the close of the fiscal year or within 30 days—whichever date is the later. All subsequent annual and interim reports are to be filed within three months and one month, respectively, after the close of the period covered. None of these reports need be certified by independent public accountants.

"O.P.A. initiated the program because of the absence of adequate financial information on large numbers of business enterprises affected by price action. The 1940 corporation income-tax returns show there were 69,000 companies, each having assets of \$250,000 or more, and that 30,000 of these were in the wholesale trade or retail trade or in manufacturing, construction, mining, and agricultural fields. However, O.P.A. pointed out, only about 2,500 of these companies are required to file with the Securities and Exchange Commission and a great number of these are duplicated in the smaller list which contributed to the survey of Industrial Corporation Reports conducted by the F.T.C.

"Time 'lags' in filing, the difficulty of assembling, and the technical weaknesses for O.P.A. needs in the material available in other reports—such as the F.T.C., S.E.C., income tax, bank, and credit reports—even if they were legally accessible and readily available would hamper O.P.A.'s efforts to keep price-control actions abreast of current business conditions.

"The confidential nature of the reports will be strictly observed, the Administrator said, although the reports will be available on a confidential basis to war planning agencies, such as the War Production Board, when needed, thus providing a centralized regularly recurring source of information for such agencies.

"The forms have been prepared in cooperation with national accounting and professional organizations

and have been simplified so as to avoid placing an unreasonable burden on industry. The reports are consistent with customary accounting statement presentation and call for few details not customary in most other reports furnished by corporations to stockholders, banks, and creditors. They ease the burden for some companies of supplying over-all cost data to O.P.A. in connection with individual requests for specific costs of each of a variety of products, since the one report will now be the only request for over-all data as to the company's operations. Similarly, time and expense is saved companies which might request special treatment under a price schedule because with general information made available by the report, the preliminary investigational work is eliminated and the actual field work expedited and confined to matters raised by the particular request.

"The reports will also make possible the compilation for each industry, or for a group of companies producing a given product, significant over-all items such as sales, cost of goods sold, operating profit and net profit before taxes, and to relate these data to inventories, fixed assets, surplus and capital.

"To provide a better base for studying the reports certain non-financial information is requested in the annual reports. This includes disclosure as to whether a reporting company is independent or is one of a group united through stock ownership or other means of control, identification of the persons exercising the principal executive functions, a description of the kind of business in which the company is engaged, the methods used in distributing its products or services, the relative importance of its various products and lists of the principal plants and other properties which a company may own. Developments as to wage rates, raw-material prices, and major accounting policies are also required

to be described. Operations conducted through subsidiaries, however, need only briefly be described by the reporting company since direct requests will be made to subsidiaries where information as to them is desired.

"The remaining item in both reports calls for certain financial statements and schedules to be filed for the reporting company on an individual, corporate basis. If a company customarily prepares statements which consolidate its accounts with one or more of its subsidiaries, statements consolidated on the basis it customarily uses are also required.

"Reviews of the reports will be made and companies will be advised of obvious inaccuracies in order to avoid the same errors in future reports. In more serious cases of error the firms will be requested to refile."

*From an article appearing in June, 1942  
JOURNAL OF ACCOUNTANCY.*

### **Activities of the S.E.C. in Accounting and Auditing**

SECURITIES AND EXCHANGE COMMISSION  
Seventh Annual Report  
Year ended June 30, 1941

#### *Excerpts:*

"As has been emphasized in previous annual reports, much of the material filed with the Commission takes the form of financial statements. The utility of such statements is clearly and directly dependent upon the soundness of the accounting principles followed in their preparation, and in the quality and independence of the work of the public accountant whose certificate accompanies them. Improvement and clarification of auditing and accounting standards and insistence upon the independence of certifying accountants are, therefore, objectives of major importance to the Commission.

#### **Auditing**

"The Sixth Annual Report of the Commission . . . indicated that, for the time being at least, the Commission would not seek to prescribe in detail the scope of and procedures to be followed in audits of the various types of registrants but instead

would await the outcome of efforts of the accounting profession which had taken concrete form in the publication of several bulletins and resolutions embodying material extensions of auditing procedure. However, it was also indicated that the Commission's requirements as to the form and content of accountants' certificates would be revised to overcome certain shortcomings in such certificates as disclosed by its studies.

"In furtherance of this program and after extended correspondence and discussion with committees of the several professional associations of accountants and a large group of other interested persons, the Commission promulgated amendments to its rules as to certification on February 5, 1941.<sup>1</sup> Both positive representations as to the scope and character of the work done and express indication of normal procedures omitted must now be included in the certificate in order to conform to . . . Regulation S-X, as amended; . . .

"The new requirements have not been in force for a period long enough to warrant definitive conclusions as to their effect. It may be expected, however, that limitations imposed by management or normal procedures omitted through personal preferences will not henceforth escape disclosure and consequent administrative review, so far as reports filed with this Commission are concerned. While the revised rule is applicable only to reports subject to the Commission's jurisdiction, yet the committee on auditing procedure of the American Institute of Accountants has taken the position that 'As a practical matter, however, practicing accountants may in course of time consider it advisable to apply the same standards of disclosure in reports for other purposes also, though the old form will doubtless continue to be used for an intermediate period.'<sup>2</sup> It may be noted in this connection that Sections 30 and 32 of the Investment Company Act of 1940 incorporate requirements as to accountants' certificates, the scope of the underlying audit, and the selection of auditors that are substantially similar to the recommendations contained in the McKesson report and the revised rule 2-02 of Regulation S-X. Section 30, however, is applicable not only to certificates required to be included in reports to this Commission but also to certificates required to be included in reports to stockholders. The section further introduces the significant requirement that reports to stockholders 'shall not be misleading in any material respect in the light of the reports' required to be filed with the Commission. . . .

<sup>1</sup> S.E.C. Accounting Series Release No. 21.

<sup>2</sup> American Institute of Accountants, Statements on Auditing Procedure, Bulletin No. 6, March, 1941.



## Professional Comment

[The report then summarizes several opinions of the Commission in cases involving questions of auditing procedure and accountants' reports.]

"To these formal decisions involving questions as to auditing procedures there should be added many more cases which have been informally resolved through discussion and conference between registrants, their accountants, and members of the Commission's staff. It appears from such conferences that the recommended extensions of auditing procedures to include physical checking or observation of inventory procedure, circularization of receivables, and more incisive analysis of the system of internal check and control are in fact being applied.

### Professional Conduct

"No less important than the maintenance of sound auditing standards is the maintenance of high standards of independence and of professional conduct among certifying accountants.

"The Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 all incorporate the concept of independence as a prerequisite to certification by public accountants. The Commission's rules have always required independence in fact, and have refused to consider an accountant independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee. Accounting Series Release No. 22<sup>3</sup> first summarized previous stop order decisions on the point as follows:

"*In the Matter of Cornucopia Gold Mines*, 1 S.E.C. 364 (1936), the Commission held that the certification of a balance-sheet prepared by an employee of the certifying accountants, who was also serving as the unsalaried but principal financial and accounting officer of the registrant, and who was a shareholder of the registrant, was not a certification by an independent accountant. *In the Matter of Rickard Ramore Gold Mines, Ltd.*, 2 S.E.C. 377 (1937), an accountant was held to be not independent by reason of the fact that he was an employee or partner of another accountant who owned a large block of stock issued to him by the registrant for services in connection with its organization. *In the Matter of American Terminals and Transit Company* 1 S.E.C. 701 (1936), conscious falsification of the facts by the certifying accountant was held to rebut the presumption of independence arising from an absence of di-

rect interest or employment. *In the Matter of Metropolitan Personal Loan Company*, 2 S.E.C. 803 (1937), it was held that accountants who completely subordinate their judgment to the desires of their client are not independent. *In the Matter of A. Hollander & Son, Inc.*, Securities Exchange Act of 1934, Release No. 2777 (1941), the Commission held that an accountant could not be considered independent when the combined holdings of himself, one of his partners, and their wives in the stock of the registrant had a substantial aggregate market value and constituted over a period of four years from 1½ per cent to 9 per cent of the combined personal fortunes of these persons. It was also held to be evidence of lack of independence, with respect to the registrant, that the accountant had made loans to, and received loans from, the registrant's officers and directors. In the same case, the evidence showed that registrant's president, over a period of years, had used the accountant's name as a false caption for an account on the books of an affiliate not audited by such accountant and that upon learning of these facts the accountant protested and procured a letter of indemnification in connection with such use. It was held that this continued use of the accountant's name, after his protest, and the overriding attitude apparently assumed by the registrant's president in this matter, constituted additional evidence of lack of independence.

"The release then went on to express the opinion that when an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, the accountant could not be recognized as independent.

"*In the Matter of A. Hollander & Son, Inc.*,<sup>4</sup> the Commission outlined the considerations underlying the general concept of independence in these words:

"We cannot, however, accept the theory advanced by counsel for the interveners that lack of independence is established only by the actual coloring or falsification of the financial statements or actual fraud or deceit. To adopt such an interpretation would be to ignore the fact that one of the purposes of requiring a certificate by an independent public accountant is to remove the possibility of impalpable and unprovable biases which an accountant may unconsciously acquire because of his intimate nonprofessional contacts with his client. The requirement for certification by an independent public accountant is not so much a guarantee against conscious falsification

<sup>3</sup> Published March 14, 1941.

<sup>4</sup> S.E.C. 586 (1941).

or intentional deception as it is a measure to insure complete objectivity. It is in part to protect the accounting profession from the implication that slight carelessness or the choice of a debatable accounting procedure is the result of bias or lack of independence that this Commission has in its prior decisions adopted objective standards. Viewing our requirements in this light, any inferences of a personal nature that may be directed against specific members of the accounting profession depend upon the facts of a particular case and do not flow from the undifferentiated application of uniform objective standards.

"Cognate though not identical problems of ethics have arisen in a number of cases. State laws governing the issuance and revocation of licenses to practice as a certified public accountant or as a public accountant have recognized the necessity of maintaining high standards of professional conduct. The accounting profession through its national and state organizations has voluntarily established codes of ethics. Violation of these standards, established after appropriate hearings, may be grounds for public admonition, for suspension or expulsion from the societies, or, in the case of state regulatory bodies, for revocation of the license to practice. Strengthening revisions of the code were made by the American Institute of Accountants and by several state societies during the past year. Because of its direct bearing on the accounting work of the Commission, the revised rule 5 of the American Institute of Accountants' 'Rules of Professional Conduct' may be quoted:

"(5) In expressing an opinion on representations in financial statements which he has examined, a member or an associate shall be held guilty of an act discreditable to the profession if:

"(a) He fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or

"(b) He fails to report any material misstatement known to him to appear in the financial statements; or

"(c) He is grossly negligent in the conduct of his examination or in making his report thereon; or

"(d) He fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

"(e) He fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted

auditing procedure applicable in the circumstances."

"In view of the existence of disciplinary machinery of this character, it is the practice of the Commission to bring to the attention of the appropriate societies and state agencies each case in which the Commission has publicly criticized the work or professional conduct of accountants practicing before it. During the past year, for example, the council of the American Institute of Accountants sitting as a trial board on five cases called to its attention by the Commission found two members guilty as charged, one of whom was suspended and the other publicly admonished. The remaining three were found not guilty, although in each case a published statement reviewed the facts (without names) and indicated disapproval of certain of the practices."

"Voluntary disciplinary machinery of this kind can, if its sanctions are vigorously and uniformly applied, be of great importance in the maintenance of proper standards of professional conduct. It cannot, however, supplant or remove the Commission's direct disciplinary authority under its Rules of Practice. Rule II(g) of these rules includes as practice before the Commission the preparation of any statement, opinion, or other paper by an accountant, filed with the Commission with his consent. Rule II(c) provides that:

"The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to, any person who is found by the Commission after hearing in the matter

"(1) Not to possess the requisite qualifications to represent others; or

"(2) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

"Moreover, it should be noted that during the past year two certified public accountants were indicted and two others convicted as a result of criminal proceedings in which the Commission participated.

### Accounting

"As in past years, the greater part of the Commission's accounting work consists of the review of financial statements to determine compliance with the Commission's requirements and conformity to generally accepted accounting principles. Moreover, while formal opinions, rules, regulations, and accounting series releases establish standards of accounting to be observed by registrants, a much larger part of the effort of the Commission to improve accounting practice under the securi-

<sup>8</sup> See JOURNAL OF ACCOUNTANCY, Vol. LXX, p. 487 (1940) and Vol. LXXII, p. 89 (1941).



ties acts takes place in informal conferences between registrants, their accountants and counsel, and the Commission's staff. Such conferences deal principally with the application of rules to particular situations and with the determination of accounting principles applicable in the absence of specific rules. For the most part such conferences settle the issue by agreement and in many cases lead to the selection, out of several generally recognized modes of treatment, of what may be termed the most preferable method. . . .

The report here summarizes opinions of the Commission dealing with questions of accounting procedure.]

#### Miscellaneous Research

"Among other accounting research work performed during the year was the beginning of an extensive survey and study of annual reports to stockholders as compared with annual reports filed by industrial and commercial companies with this Commission under the Securities Exchange Act of 1934. The objective of this study will be to determine, if possible, the extent to which the Commission's rules and decisions on accounting matters have influenced reports to stockholders which, with the exception of companies registered under the Investment Company Act of 1940, are not ordinarily subject to the jurisdiction of the Commission, and whether the financial statements accompanying such reports are in form, content, and disclosure reasonably consistent with and comparable to statements filed with this Commission. The study, however, has not progressed sufficiently to warrant a substantive report of its results.

#### Cooperation with Professional Organizations

"The development of uniform standards and practice in major accounting questions continues to be a common objective of the Commission and the accounting profession. Outstanding among efforts of professional associations toward this goal was the publication by the executive committee of the American Accounting Association, in June, 1941, of a revised 'Statement of Account-

ing Principles Underlying Corporate Financial Statements.' Originally published in 1936, the statement gave rise to a very large volume of critical comment and discussion. The present revision should further stimulate progress toward its announced objective, the expression of a unified and coordinated body of accounting theory to the end that financial statements may be both intelligible and, as far as possible, comparable with statements of other periods and other corporations. Efforts of the authorized committees of the American Institute of Accountants toward improved accounting procedure resulted in the publication of seven official bulletins setting forth recommended procedure with respect to such auditing and accounting problems as the weight to be given a client's representations as to inventories and liabilities; the treatment of certain contingent liabilities; the accountant's certificate; accounting terminology; and combined income and surplus statements.

"In connection with the promulgation of accounting series opinions and accounting rules, the practice of the Commission was continued of securing the comments and suggestions of cooperating committees of the various professional societies interested in accounting and of other interested persons. Many of the suggestions received in this manner are reflected in the substance of the rule or opinion as finally issued.

"Not less important than the official and semi-official publications are the papers presented at regular and annual meetings of the various societies and at accounting clinics and conferences frequently sponsored by leading universities and accounting societies. In addition to the educational value of such public discussions, the published papers form a valuable addition to accounting literature on a wide variety of important issues and may be taken as a continuing indication of professional efforts to improve and clarify accounting and auditing procedures. Various members of the Commission and its staff have participated, from time to time, in such meetings."

*Reprinted from June, 1942 JOURNAL OF ACCOUNTANCY.*

## United States Defense Savings Bonds Are

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# The Accountant's View on Profit Limitation

By WALTER A. STAUB, C.P.A.

THE accountant's view on the principle of limitation on profits derived from war contracts is presumably not different from that of our citizenry generally. There appears to be general agreement among thinking folk that it is not to the interest of the country that anyone should become rich from the misery and sacrifice that war brings to any people—even the victors—when it is engaged in the type of total war which modern man has evolved.

Among the forms which such profit limitation might take are the following:

- (a) taxation through a general excess profits statute;
- (b) "renegotiation" between contractor and interested government department or agency;
- (c) determination of excess profits under such a law as the Vinson Act, which was suspended for the duration of the present excess profits tax.

If the most recent proposal of the House Ways and Means Committee for a 94 per cent excess profits tax should finally become law, it would seem that from a practical standpoint a drastic limitation on profits from war contracts has become effective.

With an excess profits tax rate of 94 per cent the only profit remaining which could be termed excess war profit would be the 6 per cent. A member of the Ways and Means Committee stated that the Committee had considered a flat excess profits rate of 100 per cent, but reduced it to 94 per cent so that there would be some small incentive for the manufacturer.

There would be no advantage in offering this small percentage if it were to be taken away in some other manner.

In considering this "incentive" of 6 per cent which the contractor is permitted to retain of the so-called excess profits it should be borne in mind that it is 6 per cent of the net profit and not 6 per cent of the amount of the contract. This distinction is especially important because of the apparent vagueness of thinking on the subject as evidenced by a constant repetition of the phrase "permitting only 6 per cent" but not specifying on what the 6 per cent should be based: whether on sales, on cost of the contract, on invested capital, on pre-war earnings, or on some other base figure.

## The Excess Profits Tax

As in the case of excess profits taxes generally, a flat excess profits tax rate of 94 per cent might not be objectionable if it were possible to define excess profits in a manner which would work fairly among corporations in general. No one has as yet been, or probably ever will be, able to define excess profits in a satisfactory manner. In spite of any relief provisions which an excess profits tax law may contain—and the present law contains limited and relatively ineffective relief provisions—any excess profits tax law must define excess profits in more or less arbitrary terms, so that the impact of the tax on different corporations is bound to be more or less a matter of "happenstance," depending on the time and manner of incorporation, the particular years in which the corporation happened to have profits

*Presented at the May 11, 1942 meeting of the Society, at the Waldorf-Astoria Hotel, New York.*

or losses, and so on. Since it is practically hopeless to expect an excess profits tax law which will work with even a modicum of fairness among different corporations, there seems to be little justification for an excess profits tax rate as high as 94 per cent. It would be much fairer to have an excess profits tax law with a much lower rate of tax and then to recover excessive profits from war contracts by some other method.

As you all know, the present law allows a choice of an invested capital credit or a base period earnings credit, and to that extent is an improvement over the excess profits tax law in effect during the last war.

#### **Invested Capital Method**

When a corporation is organized and its stock is issued for cash, the computation of its invested capital is fair and simple, assuming that there are no complications in connection with the determination of accumulated earnings or profits. However, except in the case of the smaller corporations, such cases are the exception rather than the rule. Most of the larger corporations, at least, are successors to predecessor businesses, either incorporated or unincorporated. In a large proportion of such cases the computation of invested capital involves serious difficulties and inequities. The amount of a company's invested capital is usually dependent on the date and manner of organization or reorganization of the corporation. Two corporations in exactly similar circumstances with respect to sales, profits and assets may have greatly different statutory invested capital if one of them happens to have been reorganized at a certain time and in a certain manner.

The statutory invested capital may be materially affected by the liquidation of subsidiary companies. That is, the fact that a subsidiary was or was not liquidated, and the particular year in which it was liquidated,

may make a marked difference in the invested capital of the parent corporation. Whether a corporation purchases the assets of a business, or purchases the stock of the business and then liquidates the corporation, may make a tremendous difference.

Many old corporations have not retained their earlier records, and as a result may be badly prejudiced in a determination of their invested capital.

Whether or not there happened to have been sales of stock at or about the date of organization of the corporation may have an important bearing on the amount of invested capital that it is able to establish.

Many companies do not require much invested capital. Their earnings are derived largely from personal services but the companies are unable to qualify as personal service corporations because of the restrictive provisions of the statute.

Two corporations may each have had \$1,000,000 of capital paid in and each may have lost one half million dollars. In the case of corporation "A" which did not reorganize its invested capital remained at \$1,000,000. Corporation "B" reorganized after it had lost a half million dollars, and its invested capital is thus reduced to a half million dollars.

There are many cases where the invested capital of a corporation must be determined by reference to the tax basis of securities in the hands of security holders. In some cases there are thousands of security holders involved, and it is a practical impossibility to ascertain the tax basis of securities in their hands. Even if such tax basis could be determined, the effect is that a corporation's invested capital is made to depend on stock market prices.

#### **Base Period Earnings Method**

The statute assumes that any excess of current earnings over earnings in the base period is attributable to the war, and is therefore to be sub-

jected to excess profits tax. Though this may be true in a general way, there are so many exceptions that it does not seem a strong enough premise to warrant an extreme excess profits tax rate of 94 per cent. Many corporations can demonstrate clearly from the particular facts of their business that they would have made as much or more profits under peace time conditions than under present conditions, but they may nevertheless be subject to excess profits taxes because of having a low invested capital.

The growth provision in the present statute is of considerable benefit to many corporations but here again the incidence of the provision is largely a matter of "happenstance," depending upon the particular years in which a corporation earns good profits. For example, the year 1938 was a bad year for many corporations and a good year for other corporations, regardless of any growth, but the corporations which happened to have a good year in 1938 have a tremendous advantage over the other corporations, though the first class of corporations may not have been growing at all.

We are all familiar with the feast and famine corporations which over a long period of years had had a few good years followed by a few bad years. If all the profits are taken away in the good years how can such corporations survive the bad years?

Increased earnings as compared with the base period years may be due to good management, to improved or new products, to the development of new markets, etc. Also corporations may have abnormally low base period earnings for a variety of reasons. In some cases, such as the aircraft industry, what might appear to be war-time profits represent in no small part the recoupment of losses sustained in prior years and a return on the very large expenditures made over a long period

of years for experimental and development work. The government is getting a direct benefit in these times from such work which was done during the industry's relatively dry period.

### **Uncertainties and Inequities of Excess Profits Tax**

Most business in this country is highly competitive. Consequently an excess profits tax law which in effect discriminates between competitive companies, as any excess profits tax law is bound to do, has a most serious effect. A corporation subject to an excess profits tax rate of 94 per cent can obviously not long compete with another corporation which may not be subject to any excess profits tax because of an arbitrary definition of what constitute excess profits.

The uncertainty of excess profits taxation is another important factor. Many corporations will not know for years what their actual excess profits tax liability is within quite wide limits. If the excess profits tax rate is raised to 94 per cent the uncertainty naturally is correspondingly increased.

Some corporations can make money only in those years of the cycle when there is need for their production. Is it not to the Government's interest to allow such corporations to retain enough of their profits so that they may remain in business for the time when their services are required for the next emergency program?

Let us assume however that, regardless of what has been said as to the difficulties of determining what are truly "excess profits" or "war profits," in a war-time economy we must just do the best we can to determine when such profits have accrued, the amount which should be taxed, and the tax rate. The experienced accountant immediately sees a number of reasons why the rate should not be so high that there may be serious danger of crippling

companies engaged in war production or carrying on civilian production which is essential to the maintenance of the country's economic stability. Not only the accountant, but also the business man whose recollection goes back to World War I, immediately thinks of the relatively large number of concerns which appeared to have been making large profits while the war was on but which during the postwar period found such profits to have vanished (more or less) through the catastrophic drop in the price level in 1920. Other concerns were left with a lot of souvenir bricks and mortar, representing additions to plant during the war period which were in excess of those needed after the war, or which were of a character that could not be readily adapted, at least without further investment of a substantial amount, to production of peacetime commodities.

Still further, corporations with outstanding indebtedness in respect of which they have sinking fund, serial bonds, or similar commitments which are expected in normal course to be met from current profits of the business, may find themselves very seriously embarrassed if on the one hand a large part of their so-called normal income is taken from them in normal income and surtaxes, and on the other hand almost all the excess profits are taken through a 94 per cent tax. It is not to be overlooked that the base period of 1936-1939 reflected on the whole an abnormally low period of business activity and consequently of corporate earnings. It is to be assumed that, had World War II not broken out in September, 1939, and had business recovered from the depression as had been the experience in every previous depression, many businesses in normal course would have shown larger profits in the last few years than the average of the years 1936-1939. Many of these same concerns may now be earning no more in

producing war necessities—especially if postwar contingencies are taken into account—than would have been the case had they been able to continue with their commercial business. Hence, there is a certain degree of fallacy in describing as either "excess profits" or "war profits" any increase of earnings over the base period, or over a stated rate of return on invested capital which past experience indicates is too low on the over-all basis to attract risk capital to the service of industry and consequently of the community.

### **War Reserves**

Accounting Research Bulletin No. 13 issued by the American Institute of Accountants a few months ago presented the need for reserves, particularly in the accounts of companies carrying out war contracts (though not confined to such companies), if we are to avoid some of the sad financial experiences which followed the close of World War I. That Bulletin listed eleven classes of costs and losses arising out of the war for which reserves must or may be provided, if financial statements issued during the war period are to be as dependable and useful as is possible in the light of all the uncertainties inherent in war conditions. The list was intended to be suggestive rather than all embracing. Whether the reserves in a given case are of the "must" or "may" order, or partly one and partly the other, will naturally depend on the circumstances of the particular case.

This all leads up to the conclusion that to determine taxable income subject to such a drastic rate of excess profits tax as 94 per cent, in the same manner as was used in the determination of taxable income under normal conditions, would be most unwise. The aforementioned Research Bulletin made the following timely comment on this point:

"Recognition of the necessity of

such reserves is important, not only in the interests of the business enterprise, but in the interest of the national economy as a whole. The government might well take account of this fact in its fiscal policies generally and in respect of taxation. It would be wise on the part of the government to give consideration to the recognition of provisions of this kind as deductions in the determination of taxable income subject to necessary safeguards in regard to the ultimate disposition thereof. Such a policy would tend to make taxable income more nearly reflect real income, since these reserves are intended to give recognition to costs and losses related to the war period which are real, though in many cases they cannot now be definitely measured."

The LIFO (last-in, first-out) inventory method, which is now recognized for tax purposes, has been recently adopted by some companies in the endeavor to avoid showing illusory earnings and paying taxes thereon. Even department stores have become interested in it, and some have adopted it, as shown by their latest annual reports. Formerly, they were not interested in the subject, because it did not seem applicable to their type of business and accounting methods. Other companies have hesitated to adopt the LIFO method because of technical problems in adapting their accounts to its use. In the latter case, however, management may still deem it wise to secure substantially the same result by setting up inventory reserves to reduce the amounts of inventories to approximately the LIFO basis. In that event, however, no tax benefit would be derived therefrom.

The inventory reserve, however, is only one of those which might well have the consideration of the Treasury and of Congress in dealing with

the difficult subject of war taxation.

One suggestion for the practical application of war reserves in tax returns is that the returns might be made on the basis of including, not only gross income and deductions as specified in the Internal Revenue Code, but also any reserves which the taxpayer may have set up in its books and wishes to claim in its tax returns. The tax is then to be computed in two ways: (a) on the basis of excluding any deduction for the reserves, and (b) after deducting such reserve provisions. The amount of tax under (b) would be payable in cash, but war bonds for the difference between (a) and (b) would be purchased by the taxpayer and placed in escrow, the consent of the Treasury being necessary for their release. To the extent that, after the war ends, the reserves are demonstrated to have been needed, escrowed bonds would be released to the taxpayer; to the extent that the reserves are found unnecessary, the relative amount of bonds would be surrendered to the Treasury and tax thus would have been paid on the amount of such unneeded reserves.

#### **Canada's Inventory Reserve Practice**

Our neighbor, Canada, has a provision in its Excess Profits Tax Act which allows a corporation in computing taxable excess profits (but not for income tax purposes) a reserve which in effect permits the freezing for excess profits tax purposes of a normal quantity of inventory at the price level obtaining at the outbreak of the war in September, 1939. To the extent that the inventory reserve is not actually needed, it will eventually be subjected to the excess profits tax.

This inventory provision of the Canadian Excess Profits Tax Act seems an eminently desirable one which might well have the serious consideration of our Congress so as to avoid the taxing of profits which



may be found to be such in name only, and which in the post war period vanish.

### **Renegotiation of Contracts**

One of the methods of limitation of profits which has been suggested is renegotiation between the contractor and the interested Government department or agency. The War Profits Control Act, enacted recently as Section 402 of the Sixth Supplemental War Supply Bill, now provides for such renegotiation. The effect of renegotiation will not usually represent a net gain to the Treasury of the entire reduction in the contract price, since in most cases of large profits a considerable portion thereof would in any event be received by the Treasury through the excess profits and income taxes.

There will be, of course, cases where the Government and the contractor are unable to agree on what constitutes a reasonable profit in the particular case. One method of handling such a situation would be to create a board to which the dispute would be referred and the board would make a finding of what, in its opinion, would constitute a reasonable profit in the particular case.

In such a case the board would in substance be acting as an arbitrator and, as in any arbitration, would presumably seek to consider all the factors that could be put before it by both parties to the contract, and would also be free to raise questions on its own initiative in endeavoring to determine what would be a fair percentage or amount of profit in the particular case.

The advantage of this plan would be that, in determining what constituted a reasonable profit in the particular case, all of the factors affecting the situation of that particular contractor would be considered, whereas any method which involves flat rates of tax or rates of profits, is bound to work in a discriminatory manner between different contrac-

tors who are differently situated. No one rate of profit on the volume of a contract is going to be fair because of the numerous variations between different kinds of manufacture, such, for example, as the relative rapidity or slowness of production or construction in one industry as compared with another.

The question may be raised whether the finding of such a board should be binding or whether appeal should be permitted to the courts. In practice this question is not likely to be troublesome, because under war conditions it seems probable that in most cases the contractors would be willing to accept the findings of an impartial board. Certainly, on the face of it at least, a contractor would feel he has come more nearly to getting a square deal if a disinterested agency heard his appeal than if the final decision is made by the department or agency of the Government which is the other party to the contract.

There is no measure or definition of normal or excessive profits in the War Profits Control Law. However, in the event of a radical difference of opinion between contractor and Government department or other agency as to what is a fair profit on a given contract or group of contracts, there would seem to be no reason why the suggested Board should not, after considering all phases of the case, express its opinion as to what would be a fair rate of profit, or a fair amount of profit, just as the War Labor Board seeks to pass on what may be a fair wage scale when labor and employers are unable to reach an agreement by direct negotiation. Furthermore, it would seem preferable to leave room for judgment in particular cases rather than to set up rules or formulae in a law to determine or state what may be a "fair profit."

In contrasting legislation which consists of rigid rules and detailed formulae with that which seeks to

lay down broad principles and their application with administrative judgment, it may be observed that one of the weaknesses of our present excess profits tax law is the inclusion therein of many detailed provisions which are more in the nature of regulations than basic law provisions. In this respect the present excess profits tax law is quite different from that of 1918, which confined itself more largely to a statement of taxing principles and left it to the Commissioner of Internal Revenue to work out the detailed application thereof through his regulations.

#### **Effect of "Renegotiation" on Financial Statements**

One aspect of the War Profits Control Act that is of especial importance from the viewpoint of the accountant is its effect on the financial statements of companies which are carrying out large war contracts or subcontracts. Even some years after an income statement has been published, the amount of earnings shown therein may be radically reduced by reason of renegotiation of the contracts under which the stated profits were earned. Accountants are much concerned at the present time in weighing the extent to which it may be necessary to require financial statements to bear a note calling attention to the possibility of material revision thereof if, under the provisions of the War Profits Control Act, the company's war contracts or subcontracts be made the subject of renegotiation. Thus one more factor of uncertainty is added to the inherently tentative character of financial statements, and especially of the income statement, when prepared for the relatively short period of a year or less.

#### **Tax Reserve for Post-War Rehabilitation**

The following passage in the statement which the Secretary of the Treasury made before the Ways and

Means Committee of the House of Representatives on March 3 has attracted considerable attention from accountants:

"... it is recognized that very high top, or so-called 'marginal rates,' may leave little incentive for the maintenance of efficiency in business operation. Furthermore, after the war there may well be need for a large volume of expenditure in readjusting industry and maintaining employment. For these reasons it is believed desirable that in the case of any dollar of corporate profits the receipt of which results in an increase in tax beyond perhaps eighty cents, the additional tax on such dollar shall be held by the Government to the account of the corporation and be returnable within a limited period after the war, in those cases where it is spent for new and additional capital equipment or otherwise is spent in the additional employment of labor."

Although such a provision, if enacted as a part of the 1942 Revenue Act, will not relieve a corporation of so drastic a rate as 94 per cent on its so-called excess profits, it will at least offer some aid in surmounting the difficulties of the post-war period.

#### **Fallacies of Tax Legislation**

It appears frequently to be overlooked by Congress in enacting fiscal legislation, particularly of the income or excess profits tax order, that a year is at best for most industries an arbitrary segment of financial experience; and that only a complete cycle, including both good and bad years, tells a dependable story. The same thing might be said as to the determination of profits on particular contracts. In the recent hearings before a Congressional committee concerning profits on government contracts, the newspaper reports featured a relatively small contract per-



formed by a long established company which was stated to have shown a very large rate of profit on the amount of the contract. No consideration was given to the results on other contracts which showed quite different results or to the modest percentage of profit realized on the company's business as a whole.

Attention may also be called to the fact that under Treasury Decision 5000, originally issued for the determination of costs under Vinson Act contracts, various expenditures are eliminated from costs recognized by the government as allowable under cost-plus-fixed-fee contracts. Some of these disallowed costs are perfectly normal expenses of corporations as, for example, salaries of the contractor's executive officers, expenses of the contractor's main office or regularly established branch offices, and overhead expenses, except as specifically authorized in the Decision. If, for example, a corporation goes over to practically 100% war work, as many heavy industries have now done or are doing, such expense must obviously be recognized in determining what is the rate of profit that has actually been earned in the case of given contracts or during a given period of time. It may also be emphasized that, although a government department or agency will naturally have to review the results on individual contracts, the procedure should not be in the nature of a one-way street. In other words, it is much more equitable to accept the over-all result on a group of contracts as the test rather than to demand an adjustment from a contractor on one unusually profitable contract and ignore a subnormal rate of profit, or even actual losses, on other contracts.

There is always the danger that the featuring of the relatively few instances of grossly excessive profits—which serve best the natural demands of publicity—will give a

wrong impression of the situation as a whole. It does not follow at all that, because in an isolated case which recently attracted much newspaper publicity a private secretary was treated with unexampled liberality, the war has brought all private secretaries to a state of affluence beyond the dreams of the Roman Caesars. It is unfortunate that in human experience the many not infrequently suffer for the sins of a few. The death sentence in the Public Utility Holding Company Act of 1935, in my opinion, was due more to the abuses by a relatively small number of organizers and manipulators of public utility holding companies than because utility operators as a whole were corrupt. Nevertheless, abuses by the few resulted in the drastic legislation which is costing innocent investors in the securities of such companies huge losses in spite of the fact that the legislation was ostensibly in part at least for their benefit.

In the abnormal conditions that have inevitably attended our hectic effort to move rapidly from a peacetime economy, and from an almost total absence of facilities for producing war materials, to such a volume of war production as has never before been visualized in the history of any country, it would be amazing if costs could be estimated with any approximation to accuracy. In such circumstances the only thing to do for those who are taking contracts on a fixed fee basis, as contrasted with the cost-plus-fixed-fee method, is to estimate the cost on the high side. War-time contingencies as to labor and material costs, not to mention lessened efficiency from increasing the size of an organization rapidly, are too great and hazardous to do otherwise. It would naturally follow that in the case of some contracts at least, where the contingencies and hazards have not worked out as disastrously as was feared, the rate of profit would be large. In such

circumstances renegotiation of the contract seems entirely reasonable and in fact some companies have even gone beyond that point and voluntarily returned a portion of the profits to the government without waiting for renegotiation of contracts. In the case of some companies this was done even before the recent passage of the War Profits Control Bill.

One feature of the attempted limitation of profits through the excess profits tax, the logic of which the accountant finds it difficult to understand, is the establishment of a series of brackets for the rate of return to be allowed on the invested capital employed in earning such profits. In the legislation as at present discussed, this plan would be carried still further than in the excess profits enactment of 1941, which for the first time sectionalized the invested capital. When it is realized that a corporation, although a separate legal entity, is in substance employing the capital of many different stockholders, some with only modest means, it is difficult to see any justification for saying that on the first five million dollars of the aggregate invested capital a return of 8% shall be allowed, on the next five million dollars a return of 7%, on the next 190 million dollars a return of 6%, and only 5% on any excess over the total of the foregoing amounts. There just isn't any logic to that situation so far as an accountant can see.

The same thing can, of course, be said as to the brackets of excess profits net income which were established in the Second Revenue Act of 1940 aggregating \$500,000, regardless of the relationship between net income and the excess profits credit. Indeed, the whole concept of taxation of corporations seems to have broken down under the impact of the war and is producing a result which cannot be defended from a logical standpoint or from the view of the accountant.

When it is considered also that the portion of the income of a corporation which would normally be distributed to stockholders is now to be taxed at 40 or 50% (aside from any excess profits tax) there results in effect a rate of tax on the income of small stockholders which makes a travesty of the long held principle of taxing according to ability to pay.

#### Incentive to Inefficiency?

Those whose business memory goes back to World War I will recall the widespread impression that the 80 per cent war profits tax encouraged waste in business expenditures. When (combining that war profits tax with the then income tax of 12 per cent on corporations) 82.4 cents of every dollar of profit realized after reaching the war profits bracket was payable in taxes, efficiency of operation and economy of expenditure were at a discount. If that was so under a war profits tax which let the corporation retain 17.6 cents of each dollar of profit, how much less urge has management to strive for maximum efficiency and to minimize expenditure if the excess profits tax is raised to 94 per cent, thus leaving only 6 cents out of every dollar of the excess profits retainable by the corporation which earns it.

The current issue of *Time* (May 9) has an interesting dissertation on this subject with the caption of "Incompetence and Profits." A significant sentence in it is, "... although profit is the handiest uniform measure of efficiency, the very word is politically unpopular, especially in wartime."

I fear that what I have said will not be very helpful to you, so far as selecting any one method of limiting profits as better than any other. We are facing new problems and we cannot depend on merely following the program of World War I any more in fiscal policy than in military strategy. We must not ignore the

### *The Accountant's View on Profit Limitation*

experience of the past but we must also cope with new situations and problems and seek to find the best solutions.

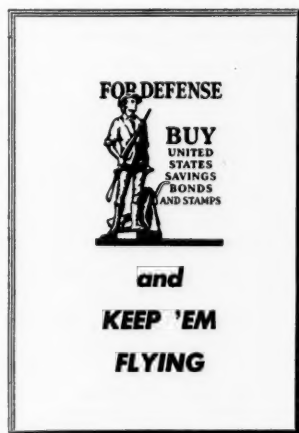
Imperfect as the excess profits tax is—and in many individual instances it may work not only hardship but relative injustice—it is a practical way of limiting profits which we obviously need to use. Its financial produce is essential. We should, however, seek to improve this form of tax, and avoid confiscatory rates.

Renegotiation is a means of profit limitation which may well prove useful when it is found that contract prices are excessive, but it is a means which needs to be used in a fair and reasonable manner. It should

not be used in such a way as to introduce uncertainty into financial statements for an indefinite number of years.

An arbitrary limitation on earnings from contracts, expressed in a blanket percentage such as has been suggested from time to time and actually proposed in Congress, does not seem to me desirable. The Secretary of the Navy advised against such legislation, and I think wisely so.

And so I leave with you the various phases of the problem of profit limitation and permit each accountant here to form his own view of the desirable solution of the problem.



# Changing Concepts of the Responsibilities of the Accountant

By VICTOR H. STEMPE, C.P.A.

## Historical background:

In retrospect, to one whose lasting impressions start with the close of the Spanish War, the economic changes which have occurred in forty odd years seem quite revolutionary, and yet those changes came gradually. "Teddy" and his "Big Stick" put teeth in anti-trust legislation which had been ineffectually administered for fifteen years or more; workmen's compensation started in Maryland in 1902, and took fifteen years to spread despite violent opposition and indignant protest of business generally (today it is taken for granted); the Federal Trade Commission and the Federal Reserve Bank both had their inception in 1914, the real beginning of effective federal regulatory control; since then, we have had a steady stream of social-economic reform and regulatory legislation, culminating in the torrent of New Deal Noble Experiments, which, with the exception of N.R.A., have probably come to stay.

The young accountant who began public practice in 1915, fresh out of the classroom and filled with academic theory which he expected to find universally observed in practice, was startled, if not disillusioned to find many successful business men contemptuous of accounting and recordkeeping and to hear them say: "I'd rather keep it in my head or on my cuff. And, in progressive business which actually had accounting departments, it was usual to find many incongruities of theory and practice, typical of which was the statement: "We don't need any provision for depreciation; the deterior-

ation of plant and facilities is more than offset by appreciation of land." Likewise, management voiced indignant protest against the plea that dividends on treasury stock did not constitute current income. Then came the "monstrous" federal income tax of 1913 which exacted one per cent of net income, as tribute to Uncle Sam for the inalienable privilege of private enterprise. Business management promptly changed its tune on depreciation to save the one per cent. As a matter of fact, the Revenue Act of 1913 was the real spring-board from which business generally took a serious "header" into respectable accounting. Prior thereto the vaunted rugged individualism of private enterprise found expression, too, in a myriad of subjective standards of accounting and financial reporting. During those days, and prior, the C. P. A. was struggling to bring order out of chaos. During the decade ended in 1915 or 1916, also, many of our present large corporations had their inception as listed companies, as the result of public offerings of stock in companies previously held closely, through mergers and consolidations, and through the phenomenal development of the automotive industry and its many satellites, big business was really unleashed in the sense of unrestrained growth, but accompanied by the cautious beginning of regulatory control which has grown constantly in strength and dominance. Recently we have had an added flood of federal control legislation dealing with war contracts, prices, rationing, and conservation, with related reg-

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ulatory commissions, which have created in Washington what one of our noble professional contemporaries called a "Kaleido-scopic Phantasmagoria."

### **Evolution of professional recognition:**

Throughout these years, and today, professional accountancy has met the challenge satisfactorily. It conceived and expanded the ingenious systems of accounting now used; found new and sound applications of accounting principles to fit the needs of enterprise; invented records; devised methods of effective internal control and internal audit; founded, sponsored, and supported colleges of commerce and accounts to train the men who have filled the ranks of the profession and private controllership, persuaded and educated management in the adoption of sound methods; fought for the recognition of sound principles of accounting and for adequate disclosure of material facts in financial reporting. In all of this the profession had the support of the Federal Reserve Board and of the Stock Exchanges, and latterly the S.E.C. has been the most important ally, in strengthening the hand of the profession by firmly fostering sound accounting and improved financial reporting.

In the early days, the C. P. A.'s practical responsibility was almost entirely to his client. As late as 1914 the profession undertook institutional promotion to persuade bankers that certified financial statements were useful documents in credit granting. Even in those days the profession foresaw its enlarging scope and influence, and publicly recognized the responsibility to those who rely upon their reports; management, stockholders, credit grantors, government bodies, and others. The changes in standards of auditing procedure, of disclosure, and of accounting practices involved no basic change in attitude, but reflected the elevation

of the standards. Within the limits of prevailing standards, accountants have always considered themselves responsible to third parties.

The individual owner or closely held corporation was, and still is, more or less a free agent. The Saturday Evening Post of May 2nd contains a fascinating story about the Knott family in Southern California, a closely knit clan that has made a phenomenal success of the berry business. The article states that the books of a business doing a half million each year are kept by one girl, on the basis of unclassified subtraction, and that Knott avoids accounting reform by snorting: "What for? We've got plenty of money in the bank!" This is probably an exaggeration, in view of attendant income tax difficulties, but the fact remains that until a man becomes involved with revenue agents, or with bankers on a basis other than mere character loans, or until he takes in partners or sells stock to outsiders, he can do pretty much as he pleases with his private accounting. However, when business decided to go "large-scale" it found sound accounting indispensable. Government regulation of business finds accounting the keystone of such control.

One has to be reminded that in the last hundred years American Society has changed from a pioneering and agricultural basis to a highly complex industrial economy. In the evolution from sole proprietorships to partnerships, to corporations, to giant business combinations, the constant increase in size and complexity necessitated an increasingly closer integration and analysis of accounts. Without sound and efficient accounting, management loses its grasp of the interrelation of detail. With the pyramiding of detail, new methods and greater skill are needed to retain that grasp. This increasingly important task gave accountancy true professional status with commensurate recognition and related responsibility.

As capitalism succeeded feudalism in Europe, traders developed the Law Merchant to govern their dealings, but ultimately the Law Merchant became part of the Common Law, and thereby the Common Law assumed the responsibility of administering the rules of competitive markets. So too, as the dealings of private enterprise affected more and more individuals and entities it became more and more charged with a public interest. To some, this appears as an inevitable evil arising out of what Burnham calls the managerial revolution. Burnham points out that in the process of growth and diffusion of stockholding, ownership has increasingly relinquished the direct control of the instruments of production into the hands of employed management; that employed management is more concerned with the perpetuation of its own entrenched power and emoluments than in the retention of unrestrained property rights, and that this offered government regulation less resistance than when ownership retained de facto control of the instruments of production. Accounting methods have become so inextricably interwoven with the current economic processes, that regulatory control cannot be exercised without the law itself assuring that sound principles of accounting are observed.

William Werntz, chief accountant of the S. E. C. who is also serving as consultant to the Office of Price Administration, says in the May 1, 1942, NACA Bulletin:

*"Within the next few weeks some 25,000 American business corporations will be asked to file with O.P.A. basic financial information for the year 1941 and the first quarter of 1942. The request will initiate a program of interim and annual reports designed to furnish O.P.A. with general financial information as a background for the more specific detail of inquiries as*

*to prices, unit costs, and other data relevant to the problem of price control."*

During recent years the respect in which the profession is held has been evident from the fact that the counsel and advice of its authorized committees had been sought by many government agencies and regulatory commissions in the formulation of accounting regulations pursuant to the administrative laws under which these bodies operate. In the case of O.P.A. there is much satisfaction in knowing that the report forms devised under Mr. Werntz's direction have been issued only after mature consideration and after consultation with committees of the American Accounting Association, the Controller's Institute, the National Association of Cost Accountants, and the American Institute of Accountants. Such conferences were held in December and late in February resulting in simplification and clarification of the requirements. Participation in these proceedings carries with it an added responsibility in fostering generally recognized accounting principles for the protection of all concerned.

There are trends in some quarters which would impose upon the profession, the burden of policing those subject to regulatory laws; for example, wage and hour agents have suggested that certifying accountants should disclose violations of the Fair Labor Standards Act on the part of their clients. Also, one gains the impression that some officials of the S.E.C. regard it as a duty of accountants to help enforce the provisions of the Acts rather than merely to disclose what they find. In the face of the ever increasing volume of rules, regulations and decisions pursuant to administrative law, this contemplates a superhuman task. When the accountant finds apparent or inadvertent infractions of these laws, he naturally reports them to



his client for corrective measures, but in the process of sampling and testing, he cannot undertake the responsibility of finding every conceivable infraction, nor is the concept of policing compatible with that of independence.

A group of English accountants, writing anonymously in the *Accountant* (London) in the issues of January 3rd through the 24th, 1942 make the radical suggestion that accountants should be equipped to pass on the social utility of business enterprises, holding themselves accountable to the public rather than merely to stockholders, credit grantors, or other directly interested parties. The *Journal of Accountancy* for April, 1942 dealt with these articles in a skillful editorial:

*"What superman will make himself the final judge of whether in a specific enterprise the best interests of Society are being served by the investment of just so much capital, the use of just so much of the country's natural resources, the fixing of prices at just such an amount, the employment of just so much of the available labor supply, the payment of just so much wages, salaries, taxes, and dividends? Yet an imperfect answer to any of these questions would constitute anti-social behavior in view of the authors. \* \* \* the accountant who attempts the task of super-police-man, even with government support, will, in our opinion, confuse everybody, accomplish nothing, and make himself very unhappy."*

#### Basic aspects of responsibility:

The responsibilities of the profession, are essentially self-imposed obligations. He who asserts professional skill, claims knowledge and experience requisite to the practice of his art. Rightly, the hiring of his skill rears related responsibilities at law.

The profession defines for itself,

and for the public, the nature and scope of the technical service which it seeks to perform. Primarily, that service is the expression of professional opinions, with due regard to exceptions, that the financial representations made by clients are fair and in conformity with generally accepted accounting principles consistently applied. The related duty imposed upon the C.P.A. by the profession is to satisfy himself by generally accepted auditing standards that he may express such opinions. Certainly, the C.P.A. should be protected against the infliction of false and far-fetched obligations which he never presumed to assume; but he neither seeks nor expects immunity from the legal liability related to his true professional obligation. He does not hold himself out as a guarantor or insurer, nor does he pose as an appraiser, valuer, or expert in materials. He does profess thorough technical knowledge of accounting and auditing, and skilled judgment in the interpretation of accounting matters. These responsibilities have not changed in essence since the inception of the profession in this country.

Those who pioneered in professional practice demonstrated the will to build soundly and to give unsparingly of their time and ability in the dissemination of knowledge, the development of better methods and the propagation of ethical ideals and professional cooperation. Professional status demands the sharing of knowledge and experience with fellow practitioners and assistants, as well as an obligation to be honorably helpful to our fellows in distress. Neither disparagement nor complacency have a place in the relations between men in a professional group; an unbiased, judicial, and sympathetic attitude toward professional contemporaries, promotes strength within, and public respect for any profession. In sponsoring the best interests of the group, the whole-

hearted recognition of these latter responsibilities is vital.

No other profession bears wider responsibilities nor assumes heavier hazards in relation to financial reward than does accountancy. No other profession has set for itself the same unique standard of unbiased independence. The C.P.A. has always recognized a duty to his clients, investors, and creditors.

#### **Professional independence:**

The roots of the accountants' usefulness lie in his independence. If he is not independent of his client, he is of little use to stockholders or credit grantors. If he is not independent of credit grantors, his usefulness to his client is impaired. If he is not independent of regulatory commissions, he may as well be on their payroll. The basic concept of the C.P.A.'s function is his ability to act as arbiter and interpreter between conflicting interests; he must be independent of them all. His integrity must be beyond suspicion; his standards must be high and strictly self-enforced.

As F. H. Hurdman pointed out in his article in the *Journal* of January, 1942, the profession has always "tacitly taken it for granted that independence was a state of mind; that if the accountant exercised professional skill honestly, applied his best judgment without fear or favor, and expressed his opinion impartially and objectively, he was independent." In respect of "independence," however, as in most other aspects of professional accountancy the gradual change in concepts has been based upon objective tests. Under these objective tests, an accountant of highest integrity will not be considered independent if he holds a financial interest in the client's business, or if he has been connected with the client as a promoter, underwriter, voting trustee, director, officer, or employee. There is indication that the S.E.C. is disposed to

view many other minor circumstances as evidence of lack of independence, no one of which alone could be so construed, but which in the aggregate may arouse such doubt. The theory of functional independence has always been recognized by C.P.A.'s; the incompatibility of serving both as director and independent auditor, or as internal accountant and external auditor, likewise, has been opposed for many years on the same grounds that it is functionally incompatible for a man to serve both as treasurer and controller of a corporation; but the advent of Securities and Exchange legislation sharpened attention to this phase of professional practice to the extent that the council of the Institute has indicated that it will henceforth apply more strictly the existing rules of conduct concerning financial interest in client's businesses.

#### **Legal liability:**

Unpleasant though the subject may be, perhaps the most vital threat to the peace of mind and financial security of the C.P.A. is the transition which has occurred in the legal liability attendant upon professional practice. His moral responsibility is to do his best to reveal the material facts to all concerned; his legal liability may involve financial restitution for error. Every accountant owes it to himself and to the profession to familiarize himself with these changes. Neither the occasion nor time permit a tedious technical review, but a hasty summary of significant aspects is in order.

The subject has been admirably covered in Spencer Gordon's article in the "Papers on Auditing Procedure," published after the annual meeting of the Institute in 1939, and in the article by A. L. Blume, in the *Journal* of March, 1941. Until recent years, the courts held, in effect, that the accountant was liable to the whole world for fraud, but only to



his employer for negligence. The late Justice Cardozo added a new concept, creating the area of constructive fraud, in which an accountant might be found guilty even though his intentions were admittedly honest.

In holding himself out as an expert and offering an opinion which might be interpreted as a representation of fact, he might be found guilty of constructive fraud if his examination were held to be inadequate or so negligent as to lead the jury to the conclusion that the examination did not provide adequate knowledge for the opinion he expressed. Under such conditions, the accountant may be found guilty of fraud, and therefore, liable to parties with whom he had no contractual relations, but who may have relied on his statement. Despite the profession's concept of audit by means of sampling and testing, and although there may have been collusive fraud practiced by management, the jury might still find that his examination was inadequate to warrant an opinion, and the accountant's liability would then extend to any who relied upon his statement.

The natural tendency of jurors unfamiliar with accounting is to regard the auditor as one charged with infallibility and to resolve the facts, on hindsight, far too rigidly.

The law governing the liability of accountants in this country is still evolving. The Securities and Exchange Acts have increased the accountants' potential liability: (a) the contractual relationship as a basis for suit in cases *not* involving fraud has been eliminated, (b) the burden is placed upon the accountant to prove that his certificate was *not* negligently or fraudulently made, (c) the standard of reasonableness is that required of a prudent *man* in the management of his own property as opposed to the common law standard of care and skill which reasonably prudent and skillful accountants would

use in the circumstance, and (d) the burden of proof is also on the accountant to show that any part of the damage sustained was *not* caused by the accountant's error. In these circumstances it seems all the more urgent to crystallize pronouncements of the profession, governing the principles, practices, and procedures which may be dignified as "generally accepted accounting principles" and "generally accepted auditing standard," to strengthen the defense of such deserving cases as might otherwise go awry through conflicting testimony by reason of the lack of generally recognized standards which bear the stamp of authoritative approval.

#### **The profession in the war effort:**

What about the professional accountants' responsibilities in the war effort?

The Office of Censorship demands the withholding of information of possible use to the enemy, including specific statements about ships, shipyards, war contracts, production schedules, strategic materials on hand, plant locations, designs, etc. Accountants have a moral responsibility to assist their clients in avoiding inadvertent disclosures of this character, in reports to stockholders or otherwise. The S.E.C. has announced a rule providing for confidential treatment of such data in reports filed with it.

As individuals, the members of the profession have already made a splendid contribution to the war effort. Many accountants and accounting students have joined the fighting forces; many are in the civilian war agencies, and others hold high ranking commissions in the army and navy in cost and audit work and in financial and budgetary administration. These men, and others who have left the profession to serve essential war industries have made a large hole in the ranks of the pro-

fession; yet despite this handicap, the profession must continue to render accounting and auditing services to facilitate production and efficient operation in war industries and in enterprises which are essential to wartime civilian economy.

For the organized profession as such, the Institute and N.A.C.A. have diligently advocated to Selective Service the issuance of a directive which will permit accountants of mature experience and knowledge to remain in civilian employment when engaged either privately or professionally in essential war industries or in those essential to wartime civilian economy; believing that such men may best serve the war effort in such positions. The appeal has in no sense sought blanket deferment for any and all accountants, nor even deferment of well-qualified accountants not engaged in essential work. The communication to Selective Service appeared in the April *Journal* and merits careful consideration. No decision has been issued thus far, but there is reasonable hope that a directive to draft boards, dealing with accountants, will appear soon.

A subcommittee of the Institute's Committee on Auditing Procedure in collaboration with a similar committee of the New York State Society, has been dealing with the S.E.C. and the New York Stock Exchange with the view of making suggestions for the relief of the profession's difficulties arising out of war conditions. These negotiations have stressed the fact that the need for accounting and auditing services, particularly by industries engaged in war work, has increased substantially; on the other hand the staffs of professional accountants have been seriously depleted, with the likelihood that the situation may be aggravated. The condition may be alleviated (a) by a relaxation of auditing standards or (b) by spreading the work more evenly over the year, thereby afford-

ing more efficient use of available personnel.

The Institute's subcommittee, the Committee on Auditing Procedure as a whole, and the Institute's executive committee, without dissenting view, are all firmly of the opinion that such work as is performed should be well done, that there should be no relaxation of standards, that the responsibilities and legal liabilities of professional accountants are such as to preclude such relaxation. While situations may arise where qualified opinions may be appropriate or unavoidable, the general adoption of such practice would create a most undesirable and unsatisfactory situation, contrary to the public interest.

The subcommittee will issue a report encouraging a maximum amount of interim work in respect of the review of internal control, staggered test and observation of inventories and direct communication with debtors, to the extent to which conditions justify such procedure at dates before the fiscal year-end. The Institute's committee on public information has recently issued a pamphlet urging more extensive adoption of the natural business year, and the S.E.C. and the Stock Exchange have been urged to exercise their powers, or persuasion, to induce companies to make such appropriate changes. Also, the Commission has been asked to grant blanket extensions of 120 to 180 days after the close of fiscal years for the filing of 10-K reports, and to permit within reasonable bounds, the consolidation of subsidiary financial statements for full years ended not more than 93 days before that of the parent company. Furthermore, the Stock Exchange has been asked, in respect of companies whose fiscal years end on December 31st, to (a) suspend the requirement for the filing of financial statements within three months (b) encourage postponement of annual meetings, and (c) modify the 20-day rule as to issuance of annual reports so as to re-

late that period to the date of adjourned annual meetings. These proposals do not alter the responsibilities of C.P.A.'s, but they may serve to spread the work and thereby alleviate the strain. It is hoped that other appropriate proposals may evolve in due course; suggestions will be welcomed by the committee.

### What about the future:

Intent though we are upon the immediate problems of the day, the war is being fought for the survival of democratic ideals and the hope that the post-war period may restore peace and plenty. Under what economic and social policies will the U.S.A. pursue reconstruction, and what will be the status of accountancy? Will we have a planned economy, or free enterprise with a minimum of government regulation? Will the government discourage private enterprise, accepting the theory of a matured economy which demands public spending? Accountants with their intimate knowledge of how business operates, and how taxation and regulatory legislation affect it, have a moral obligation to influence their fellow citizens in their thinking on this vital subject.

Stuart Chase is now engaged upon a series of exploratory reports on post-war problems for the Twentieth Century Fund. The first of these, entitled "The Road We Are Traveling", was issued March 3rd. It is written in Chase's bold, imaginative and provocative style. Were it not for erroneous conclusions involving matters of accounting in his previous writings, one might easily be persuaded to a belief that a planned economy is the only way out. He views a return to free enterprise as a futile dream, and says:

*"If the world could not retreat to free enterprise after the last war—when the victors strongly desired it—is there any hope that retreat will be possible after this war? On the*

*basis of the twenty-five year record, there appears to be none."*

Chase obviously shares the gloomy philosophy of a matured economy and believes that the days of new enterprise are past, scorning the concept of technological frontiers. Defeatist philosophy, reform legislation, inordinate taxation and uncertainty stifled free enterprise during the last decade. Speaking of the decline in investment opportunities, Chase refers to the boon of automotive industries in the twenties, and grudgingly says: "A cheap airplane which anyone could fly might expand the frontier again. Will we get it after the war?" American progress and prosperity were built through the industry and thrift of its people; individual incentive and initiative carried us to where we are now. Restore the profit motive with a reasonable degree of freedom of action and security of legitimate use and we shall again eliminate the tragic unemployment of patient money and frustrated manpower.

The president of the American Economic Association, Sumner H. Slichter of Harvard, delivered an inspiring address at the annual meeting in New York on December 29, 1941, in which he admitted that post-war planning must contemplate important changes in policies and institutions. He warns that the clash of special interests can throttle production and thereby stifle free enterprise, whereas if special interests can be induced to exercise restraint and foster the promotion of common interests, long-term unemployment can be prevented. He concluded with the following statement:

*"The possibilities of modern technology are tremendous. If these possibilities can be realized, no one can doubt that we are on the threshold of gaining a far better standard of living than man has ever known. Nothing can prevent us from realizing the possibilities of modern*

*technology except unwillingness to place a high valuation upon certain common interests—particularly our interests in enterprise, experimentation, innovation. Never have the rewards of a broad view of common interests been more attractive. Never has the folly of narrowly pressing special claims been greater. The economic future of our country and of the world depends upon the clarity with which this is seen."*

#### Conclusion:

Perhaps some of us may prefer the adventure of a new social-economic order, believing that it affords the only way toward a fuller life of plenty for the greater number. It seems the safer, saner course, not to *retreat*—as Chase calls it—but to *retain* the major values of a system which has demonstrated its full worth in the rapid development of material prosperity and the more abundant enjoyment of life, liberty, and the pursuit of happiness; a system which utilizes to the greater degree the fullest measure of natural human ingenuity, incentive, and initiative.

It is not strange that foreign doctrines have influenced our own; but even abroad, whether under tyranni-

cal dictatorship or otherwise, the old socialist philosophy has been discarded. The trend has been *not* toward a direct blanket seizure of the instruments of production, but rather to a strict control and direction of the utilization of property remaining in the hands of private management (sometimes a favored few) always with the lure and usually vain hope of private gain, more often than not frustrated by a rigidly enforced planned economy. Even under these circumstances, accountancy remains a vital tool of control.

Whatever may be the post-war economic destiny of these United States, accountancy will continue to be an influential and essential profession. Our responsibilities may shift away from clients, investors, and credit grantors toward the common public interest as suggested by our anonymous British contemporaries, but these responsibilities are more apt to broaden than to be relegated to the status of mere clerical checking by prescribed government manual of rules. Whatever, the future may hold, the key to professional dignity and responsibility lies in the retention of the fullest measure of independence.

### ***It is the Patriotic Duty of Every American Citizen to:***

**GIVE to the Red Cross**

**INVEST in Defense Savings Bonds**

**SECURITIES AND EXCHANGE  
COMMISSION  
Philadelphia**

SECURITIES ACT OF 1933  
Release No. 2824

SECURITIES EXCHANGE ACT OF 1934  
Release No. 3209

INVESTMENT COMPANY ACT OF 1940  
Release No. 348

ACCOUNTING SERIES  
Release No. 33

The Securities and Exchange Commission today announced the adoption of an amendment to Regulation S-X so as to make that regulation applicable to the form and content of financial statements filed by unincorporated management investment companies which are issuers of periodic payment plan certificates. The principal change effected by the amendment causes the statement of income and other distributable funds to show separately the balance of income before gain or loss from security transactions and the gain or loss from security transactions. The amendment also includes certain clarifying changes in Article 6 and Article 6A.

The amendment is designed to adapt the present requirements for use by companies subject to the Investment Company Act of 1940, but also is applicable to statements of investment companies filed under the Securities Act of 1933 and the Securities Exchange Act of 1934. It is contemplated, however, that further amendments or a general revision of the requirements as to the form and content of financial statements of investment companies may result from study of the financial statements filed as part of the registration statements of investment companies under the Investment Company Act of 1940.

The text of the Commission's action follows:

The Securities and Exchange Commission, acting pursuant to authority conferred upon it by the Securities Act of 1933, particularly Sections 7 and 19 (a) thereof, the Securities Exchange Act of 1934, particularly Sections 12, 13, 15 (d), and 23 (a) thereof, and the Investment Company Act of 1940, particularly Sections 8, 30, and 38 (a) thereof, and deeming such action necessary and appropriate in the public interest and for the protection of investors and necessary for the execution of the functions vested in it by the said Acts, hereby amends Regulation S-X as follows:

I. The following definition is added to Rule 1-02:

*Trust*.—The term "trust" when used in Article 6A means—

(a) a unit investment trust, including

one which issues periodic payment plan certificates, when used in regard to the financial statements to be filed for such trust; and

(b) an unincorporated management investment company which issues periodic payment plan certificates when used in regard to the financial statements to be filed for such company.

II. The title of Article 6 is amended to read—

**Article 6. Management Investment  
Companies**

III. Rule 6-01 is amended to read—

*Rule 6-01. Application of Article 6.*

This article shall be applicable to financial statements filed for management investment companies other than those which are issuers of periodic payment plan certificates.

IV. The introductory clause of Rule 6-02 is amended to read—

*Rule 6-02. Balance Sheets.*

The balance sheets filed for persons to whom this article is applicable shall comply with the following provisions:

V. The introductory clause of Rule 6-03 is amended to read—

*Rule 6-03. Profit and Loss Statements.*

The profit and loss statements filed for persons to whom this article is applicable shall comply with the following provisions:

VI. Rule 6-10 is amended to read—

*Rule 6-11. Application of Article 6A.*

This article shall be applicable to financial statements filed for unit investment trusts, including those which are issuers of periodic payment plan certificates, and financial statements filed for unincorporated management investment companies which are issuers of periodic payment plan certificates.

VII. The introductory clause of Rule 6-11 is amended to read—

*Rule 6-11. Statements of Condition.*

Statements of condition filed for persons to whom this article is applicable shall comply with the following provisions:

VIII. Paragraph 1 (a) of Rule 6-11 is amended to read—

(a) *Securities of Investment Companies*.—State separately (1) trust shares in trusts created or serviced by the depositor or sponsor of this trust; (2) trust shares in other trusts; and (3) securities of other investment companies.

## The New York Certified Public Accountant

IX. Caption 8 of Rule 6-11 is amended to read—

8. *Trust Shares.*—State for each class of trust shares (a) the title of issue, the number of trust shares outstanding and the total cost to the investors of such trust shares; (b) the adjustment for market depreciation or appreciation; (c) other deductions from the total cost to the investors for fees, loads and other charges; and (d) the net amount applicable to the investors. Explain in a note referred to under this caption the deductions for fees, loads, and other charges from the total cost to the investors.

X. Caption 9 of Rule 6-11 is amended to read—

9. *Balance of Income and Distributable Funds Applicable to Trust Shares.*—The amount shown here shall agree with that shown in caption 19 of the related statement of income and distributable funds.

XI. Rule 6-12 is amended to read—

*Rule 6-12. Statements of Income and Distributable Funds.*

The statements of income and distributable funds filed for persons to whom this article is applicable shall comply with the following provisions:

### INCOME

1. *Distributions and dividends.*—State separately (a) distributions received on shares of investment trusts, and (b) dividends on other securities. Exclude any distribution or portion thereof received on shares of investment trusts which is known to represent the return of any amount invested in the shares upon which such distribution was paid. Also indicate the basis upon which dividends and distributions are taken into income (e.g., "cash" or "accrual"); and if accrual whether as of declaration or record date; and, as to any distributions and dividends other than cash, the basis on which they have been taken up as income.

2. *Interest.*—State separately interest from (a) securities and (b) other sources.

3. *Other Income.*—State separately by class of income each significant amount.

4. *Total Income.*

### EXPENSES

5. *Taxes.*

6. *Fees of the trustee and custodian.*

7. *Fees of the depositor and sponsor.*

8. *Legal fees and expenses.*—State separately each significant amount.

9. *Auditing fees and expenses.*—State separately each significant amount.

10. *Other expenses.*—State separately by class of expense each significant amount.

11. *Total expenses.*

12. *Balance of income before gain or loss realized from security transactions.*—See caption 13 below.

13. *Gain or loss realized from security transactions.*—State separately the net of gains and losses arising from transactions in (a) trust shares of trusts created or serviced by the depositor or sponsor of this trust; (b) trust shares in other trusts; and (c) other investments in securities. State here or in a note herein referred to the principle followed in determining the cost of securities sold, e.g., "average cost" or "first-in, first-out." This caption, and caption 12 above, may be omitted by unit investment trusts provided the information herein required is contained in Schedule III of Rule 6-13, and provided there be given in a footnote in the financial statements (a) the aggregate amount received from sale of securities; (b) the aggregate cost of the securities sold; (c) the realized gain or loss thereon; and (d) the principle followed in determining the cost of securities sold, e.g., "average cost" or "first-in, first-out."

14. *Net income for the period.*—If captions 12 and 13 are omitted by unit investment trusts, this caption shall be changed to *Net income for the period excluding gain or loss realized from security transactions.*

15. *Balance of income and distributable funds applicable to trust shares at the beginning of the period.*

16. *Additions to distributable funds.*—State separately (a) that portion from the sale of trust shares which represents payments for participation in the balance of income and distributable funds; and (b) any other significant amounts.

17. *Deductions other than distributions.*—State separately (a) amounts withheld (1) for reserves and (2) for investments, and (b) any other significant amounts.

18. *Distributions to shareholders.*—For each class of trust shares state the amount per share and in the aggregate. State, as to any distributions other than cash, the nature of the distributions and the basis of determining the amount charged to income and distributable funds. Indicate here or in a note herein referred to the aggregate distributions made upon the surrender and cancellation of trust shares which represent income and distributable funds applicable thereto at the date of surrender and cancellation.

19. *Balance of income and distributable funds applicable to trust shares at close of the period.*



Securities and Exchange Commission Release

XII. Rule 6-13 is amended to read—

*Rule 6-13. What Schedules are to be Filed.*

(a) Schedule IV, specified below, shall be filed as of the date of the most recent statement of condition filed. The other schedules specified shall be filed for each period for which a statement of income and distributable funds is filed. All schedules shall be certified.

(b) Reference to the schedules shall be made against the appropriate captions of the statement of condition and the statement of income and distributable funds.

*Schedule I. Investment in securities.*—The schedule prescribed by Rule 12-33 shall be filed in support of caption 1 of each statement of condition and of captions 1 and 2 of each statement of income and distributable funds.

*Schedule II. Trust shares.*—The schedule prescribed by Rule 12-34 shall be filed in support of caption 8 of each statement of condition.

*Schedule III. Gain or loss from transactions in trust property.*—A schedule shall be submitted showing for each investment set forth in Schedule I in which there were any sales or redemptions during the period: (a) the aggregate amount received from sale; (b) the aggregate cost of the investment sold; and (c) the realized gain or loss thereon.

*Schedule IV. Allocation of trust assets to series of trust shares.*—If the trust assets are specifically allocated to different series of trust shares, and if such allocation is not shown in the statement of condition in columnar form or by the submission of separate statements for each series of trust shares, a schedule shall be submitted showing the amount of trust assets, indicated by each statement of condition filed, which is applicable to each series of trust shares.

*Schedule V. Allocation of trust income and distributable funds to series of trust shares.*—If the trust income and distributable funds are specifically allocated to different series of trust shares and if such allocation is not shown in the statement of income and distributable funds in columnar form or by the submission of separate statements for each series of trust shares, a schedule shall be submitted showing the amount of income and distributable funds, indicated by each statement of income and

distributable funds filed, which is applicable to each series of trust shares.

XIII. The descriptive caption of Rule 12-33 is amended to read—

*Rule 12-33. Investments In Securities.* [1] (For all Unit Investment Trusts, and for those Unincorporated Management Investment Companies which are Issuers of Periodic Payment Plan Certificates).

XIV. Note 2 of Rule 12-33 is amended to read—

[2] Group separately (a) shares of investment companies, and (b) other securities. As to securities, set forth in group (a) list separately (1) trust shares in trusts created or serviced by the depositor or sponsor of this trust; (2) trust shares in other trusts; and (3) securities of other investment companies. As to securities set forth in group (b) list (1) evidences of indebtedness; (2) preferred shares; (3) common shares; and (4) other securities. Within each of these subdivisions classify according to type of business, insofar as possible, e.g., railroads, utilities, banks, insurance companies, industrials. Give totals of each group, subdivision, and class.

XV. The descriptive caption of Rule 12-34 is amended to read—

*Rule 12-34. Trust Shares.* (For all Unit Investment Trusts, and for those Unincorporated Management Investment Companies which are Issuers of Periodic Payment Plan Certificates.)

XVI. Note 3 of Rule 12-34 is amended to read—

[3] State separately all significant items. If market appreciation of underlying trust property is included, the amount thereof shall be shown separately. Income required to be set forth in the statement of income and distributable funds shall not be set forth here.

XVII. Note 4 of Rule 12-34 is amended to read—

[4] State separately all significant items. If market depreciation of underlying trust property is included, the amount thereof shall be shown separately. Expenses required to be set forth in the statement of income and distributable funds shall not be set forth here.

Effective April 28, 1942.

**REMEMBER PEARL HARBOR!**  
**BUY DEFENSE BONDS**

# Problems of Financial Reporting under Wartime Conditions

## Introductory Remarks by Saul Levy, C. P. A.

Vice-President of The New York State Society of Certified Public Accountants

**W**E are meeting today for the purpose of discussing "Problems of Financial Reporting under Wartime Conditions." By financial reporting, we have in mind, of course, the preparation, auditing, publication and use of financial and operating statements and reports.

The obligation to account and to report has long since become a universal phenomenon of modern business. Every investor, every business executive, every credit grantor, every taxpayer and every tax official has a vital interest in this function of business. As Certified Public Accountants we are called upon to play our part. We realize that we can render maximum service only insofar as we coordinate our efforts with all other groups who have a stake in these problems.

In an effort to bring our minds a little closer together, we have arranged today's program. It is to be a streamlined symposium where in rapid fire fashion we are to hear our subject discussed in turn from the viewpoint of the government, the securities market, the credit grantor, the tax consultant and the business executive—the almost forgotten man who usually does most of the work and always has to assume his full share of the responsibility.

The rapid transition from a peacetime to a wartime economy has relieved us of no part of our ordinary financial reporting burden. We still have to keep books of account, prepare tax returns, seek credit on the

basis of our financial statements, file reports with governmental agencies and stock exchanges, issue periodic reports to stockholders, and keep management currently informed so that business may be intelligently directed. These usual requirements are all still with us, only more so than ever. For we now have to deal with an increasing volume of business, with the manufacture of new products often under totally new physical and economic conditions, the acquisition and installation of new facilities, the change-over to double-shift and three-shift production schedules, with heavier and more complicated taxes than ever before, with innumerable unprecedented financial contingencies and accounting difficulties. Add to all this the extraordinary though essential requirements of the War Productions Board, the Office of Price Administration and of the various procurement agencies of the Government with whom, directly or indirectly as sub-contractors, we are now transacting so much of our business.

In the face of this rising tide of financial reporting work, we find it difficult or well nigh impossible to expand our personnel. Many of us would be quite content if we could only keep our present staffs intact. Many a financial executive has already found himself in a 24-hour-a-day job with not quite the human endurance to put himself on a three-shift basis.

In this predicament we must ob-

*These addresses were presented at a luncheon at the Waldorf-Astoria Hotel, New York, given by the New York State Society of Certified Public Accountants on May 26, 1942.*



viously make the most of every device or expedient that offers some measure of relief. As usual, necessity will become the mother of invention. Many interesting innovations are no doubt already in the offing. But we do not have to limit ourselves to innovations. A conspicuous bottleneck in financial reporting suggests its own remedy.

Even at this late date it is estimated that at least 75% of all business enterprises still cling to the calendar year basis of keeping their accounts, with nothing to justify or even explain this practise in most instances but the old law of inertia. This concentration of financial reporting shortly following December 31st ties up traffic all along the line. A better distribution would not only serve the entire financial community, but in most instances the individual business is neglecting its own immediate interests by its failure to shift to a natural business year. That this truth has already received wide-

spread recognition is evidenced by the fact that since 1935 over 22,000 business entities have received from the Treasury Department permission to change to a natural business year and file their tax returns accordingly. Practically all of our department stores, our large packing companies and manufacturers of agricultural implements, most of our fertilizer producers, and innumerable other large industrial enterprises have recognized the soundness of adopting a natural business year.

What is the significance of the natural business year under present day conditions? What does it offer to the individual concern and to the financial community as a means of relieving the strain of financial reporting under wartime conditions? These are questions that our speakers will deal with, each from the vantage point of his own field of work.

### Address by William W. Werntz

Chief Accountant of the Securities and Exchange Commission

The "natural business year," as a basis of financial reporting, has been explored on numerous occasions and from various points of view, with the result that there is universal agreement on the proposition that such a fiscal period offers material benefits to those who are concerned with the preparation or interpretation of financial statements—be they managers, investors, credit or investment analysts, public accountants or governmental agencies.

The Securities and Exchange Commission, which is especially concerned with the interests of investors, has on several occasions expressed the belief that a wider adoption of the natural business year would yield significant advantages to investors. Perhaps the principal

advantage to the investor lies in the increased dependability of the financial statements presented. For one thing there is less of conjecture or assumption involved in making up and in interpreting the financial statements of the company when prepared on this basis. For example, current assets and current liabilities are ordinarily at their low point, whereas at other dates the investor may have some difficulty in judging the extent to which seasonal factors have had an influence on the financial position. In many cases the operating results are more clearly defined when expressed on a natural business year basis. In many companies each natural business year is an integrated selling and producing effort that stands apart; and each

succeeding natural business year may call for a reexamination of the producing and selling policies and practices of the company. Where such conditions exist it is of doubtful analytical value to report the results of a portion of one operating cycle and a portion of another operating cycle.

To this may be added the fact that a wider adoption of the natural business year would likely result in a further refinement in the quality of the services rendered by public accountants. The Commission has frequently emphasized the significance of a review by an independent public accountant in assuring accuracy and reliability of financial statements. It is obvious that distributing the work of the public accountant more evenly throughout the year cannot help but have a favorable effect on the conditions under which he conducts his examination and formulates his opinions. Some indication of the improvement that is possible is found in the fact that about 75% of the registrants filing annual reports with the Commission under the Securities Exchange Act of 1934 still use the calendar year as a fiscal year. The next most frequent closing date, June 30, is used by something less than 5% of the registrants. The remaining companies—unfortunately a bare one-fifth of the 1934 Act registrants—have closing dates that are more or less evenly distributed throughout the remaining ten months of the year. The increasing complexity of the problems that confront the public accountant have made it more and more clear that these problems could be more effectively dealt with if the extreme stress of the calendar year closing could be alleviated.

Time does not permit a more detailed exploration of the benefits available from a more general adoption of the natural business year. However, it is well to note that these benefits are not wholly one-sided.

In many particulars these same considerations also operate to the benefit of the company. More accurate and dependable financial information is clearly of importance to management. In addition there is the possibility of reduced expense and increased efficiency in the company's internal activities in closing its books as well as in the audit of the public accountants. Furthermore, the company has the benefit of presenting its statements at a time when, in several important respects, its financial position appears most favorable.

The question of the Commission's reporting requirements for companies that change their fiscal period is of some importance to those companies that file annual reports with the Commission. Most of these annual reports are filed under the 1934 Act and Rule X-13A-4 promulgated under this Act governs the character of the report required to be filed for the interim period that results from the change in the fiscal year. In general it is necessary to file financial data for the interim period, but the time of filing and the information required depends to some extent on the length of the interim period. For a short interim period—less than three months—no separate filing of a report covering the interim period is required. However, it is required that the next annual report, which will extend to the close of the new fiscal year, shall include the interim period and shall show separate schedules and profit and loss statements for the interim period. Balance sheets as of the close of the interim period need not be furnished. If the interim period covers three months or more, a report for this period must be separately filed in a form comparable with the annual report. This interim report need not be certified if the interim period is less than six months. However, if this report is not certified the next annual report must include separate certified finan-

## *Problems of Financial Reporting under Wartime Conditions*

cial statements covering the interim period. For an interim period of six months or more the reporting requirements are similar to those for the regular annual report. In addition, there is the requirement that if the fiscal date is changed it is necessary to notify the Commission within ten days thereafter.

In conclusion, it seems to me most appropriate to repeat what I have earlier said that, to my mind, the advantages of the natural business year as a basis of financial reporting are clear and to my mind have never been shown to be outweighed by the alleged disadvantages.

### **Address by Philip L. West**

Acting Director, Department of Stock List, New York Stock Exchange

In August of 1939, a report of the Sub-Committee on Independent Audits and Audit Procedure of the Committee on Stock List was issued. This report stressed the evolutionary nature of accounting and auditing procedures and made certain recommendations as to corporate procedures looking toward making the system of internal control and audit as efficient as possible and facilitating in every reasonable way the work of the independent auditor.

One of these recommendations was for the adoption of the natural business year. We have had a generally favorable reaction to this recommendation. The big question seems to be where and when to start. It is like the traveller who was in Tennessee and wanted to go to Cincinnati, Ohio. After travelling for some time, he began to wonder whether or not he was on the right road. So he stopped and asked a farmer how to get to Cincinnati. The farmer said, "When you get down to the bottom of this hill, you will find a cross road. Turn right and that will take you to Cincinnati." He said, "No, turn left." He thought some more and said, "No, turn right." Then he said, "No, you turn left." Then he said, "Well, I'll tell you. Mister, if I were going to Cincinnati, I would not start from here."

The relationship of taxes to a change to the natural business year

is a big problem. If the tax question were solved, I am sure many companies would know where to start but, from the standpoint of many companies, it appears that the starting point is never favorable. Perhaps with many companies engaged in war work at the present time, the peaks and valleys of seasonal operations may have been ironed out temporarily and, in looking ahead to normal operations under peacetime conditions, a change could be made now without unfavorable results from the standpoint of taxes. While progress is slow, it is being made. At present, 25% of the companies listed on the New York Stock Exchange have fiscal years ending other than with the calendar year.

The calendar year may, of course, also be the natural business year. As an indication of this, approximately 35% of the companies replying to a questionnaire which was sent out several years ago indicated that they believed the calendar year corresponded or was closely related to the natural business year. In 1941, seven listed companies changed from the calendar year to another fiscal period representing their natural business year. There still remain a large number of companies in connection with which it would appear that advantages could be gained by making a change.

There are numerous advantages

to the natural business year. The more general adoption by companies in each industry would, to a large extent, smooth down the huge peaks of audit work which now occur in the early part of each calendar year. By adoption of the natural business year which conforms to the true business cycle of the particular industry, corporations may simplify their problems of year-end adjustment and reduce the cost of stocktaking, besides permitting a more efficient and more economical audit.

The income account of a company based upon a completed cycle of a normal year's operations would give the investor a fairer picture of the operations of his company. Reports

of companies in the same field of business would be directly comparable as almost all industries have their own clearly-defined natural business year. The principal difficulty which may be considered a disadvantage is for the period when the change takes place. When the cost from a tax standpoint is weighed against the advantages, the change itself may be found undesirable. It is hoped that the efforts which are being made to adjust this situation will have favorable consideration in order that this deterrent to a swing toward the natural business year which would provide better reports to security holders will be removed.

### Address by Philip F. Gray

Vice-President of Irving Trust Company, New York

Our hosts have asked me to talk to you for a few minutes regarding the use of the natural business year as it effects bank operations.

The use of the natural fiscal year is desirable from the viewpoint of the banker. The banker passing upon the application for credit wants as factual a statement as possible of the prospective borrower's financial position.

When prepared at the end of a natural year, a financial statement reflects more fact and less estimate. The reason is that inventories, always difficult of valuation under any circumstances, are at their low point; receivables also are at their lowest, and bank loans have been liquidated, or reduced to their annual minimum. In marginal cases it would be necessary to obtain additional data such as peak debt, inventory and receivables, and whether the statements were prepared at the end of the calendar or another fiscal period.

The executive whose company closes its books on the natural fiscal

year basis is in position to review past operations of his company with a greater degree of certainty as to the results of the prior year's operations and policies. Financial statements prepared on the natural business year basis reflect one complete cycle of operations, while on a calendar year basis the showing may be the result of parts of two separate business cycles.

We in the banking business are naturally in a better position to help management in its credit problems if it comes to us with statements prepared when its business is in its most liquid condition. The factors of minimum inventories, receivables and payables help us as well as the executive in determining the position of a company from the credit viewpoint.

The credit officer of any bank is interested in doing all that he can to help prospective borrowers. He wants the whole credit process to be as simple and efficient as possible. He very much desires, for one thing,

to spread his work through the year; thereby being better able to render expeditious service at all times.

Even though there may not be a concentration of applications for *actual* loans during the first three months of the calendar year—it is incumbent upon the bank credit departments to analyze annual reports promptly after receipt. Many cases are presented to the loan committee for decision as to the line of credit to be made available to the customers.

The present war emergency has created additional problems that often are time consuming, such as,

1. The necessity to extend credit far beyond normal proportionate amounts to manufacturers with large war production orders, and
2. The application of the various restrictive regulations affecting the business of the borrower.

Furthermore, credit departments of banks, as well as staffs of accounting firms, are suffering from acute shortage of personnel.

Since companies with war orders are usually on full twenty-four hour a day production schedules, it is not possible to recommend that they

change to a natural business year basis while the war is on. A company with its inventories at maximum capacity and its receivables represented in the proceeds of government contracts, would, for the present, appear to have no natural business year. Bankers, and the accountants, then must be prepared to take care of the requirements of the many war producers operating on the calendar year basis. We must continue to accept rush period conditions where the audits and credit requirements of these companies are concerned.

But, there is no reason why a company not fully engaged in production of war requirements should remain on the calendar year, unless it is established that the calendar period is also its natural business year.

Any such company can help greatly in the war effort of the nation by changing to the natural business year, not only because it will gain advantages but will clear the way for maximum service by accountants and bankers to the companies which are participating in the war effort on an all out full-time production basis.

### Address by Walter A. Cooper, C. P. A.

Chairman of Committee on Federal Taxation of the  
American Institute of Accountants

The tax problems involved in changing over to a natural business year may be summarized in a very few words though applying, to any given case, the principles which I shall outline, may be a more arduous task.

Three features are involved. They are:

- (1) The result of filing a short-period return when the change-over is accomplished.

- (2) The effect in future years of changes in the taxing statute.
- (3) The general effect of using a natural business year rather than an unnatural business year.

- (1) **The result of filing a short-period return when the change-over is accomplished:**

Changing over to a new accounting period either from a calendar

year, or some other fiscal year, may affect three taxes, to wit: the regular excess profits tax, the declared-value excess profits tax, and, to a very minor extent, the normal income tax and surtax.

For the purpose of computing the regular excess profits tax, the income for the short period resulting from the change must be annualized, that is to say, all the figures involved must be put on an annual basis on the assumption that the monthly average for the short period will continue through the remaining months necessary to complete what was formerly the full year of twelve months. So, for example, if the short period were six months, the excess profits net income for that six month's period must be multiplied by two to get the annual result. Similarly, the credits are computed on a yearly basis and the resulting tax is then apportioned on a similar monthly basis so that, to use the same illustration, the tax on annualized income for twelve months would be divided by two, to get the tax actually payable on the income for the short six months' period. As you will observe, the annualizing of the income on the basis of actual income for the short period produces a fictitious result that, in most cases, will produce either a higher or lower tax than should be payable. It results in the correct tax only if the income for the short period is a ratable portion of the income for the full twelve months. As a rule, that is not so when seasonal businesses are involved. If the short period should have resulted in earnings higher than the normal monthly average for twelve months, the resulting tax will be higher than should be fairly charged. On the other hand, if the income for the short period should be less than a ratable portion of the twelve months' income, the tax will be abnormally low. The result, therefore, depends

upon the circumstances of each case. I should add, however, that the Committee on Federal Taxation, of the American Institute of Accountants, has urged that Congress amend the law to provide for annualizing the income on the basis of actual results rather than fictitious results. Under our proposal, the income for the theoretical twelve months would be obtained by adding to the actual income for the short period the actual income of the succeeding months necessary to complete a twelve-month period, and then assessing as the tax that proportion of the tax on the actual income for the twelve months which the actual income for the short period bears to the total actual income for the twelve months. If the law should be so amended, then there will be neither advantage nor disadvantage so far as the change-over period is concerned. If it is not changed, it might work either way, depending upon the facts.

As for the declared-value excess profits tax, no annualizing is required so that having to file a return for the short period will result either in the same tax that would otherwise be payable or a lesser tax (usually the latter), because an exemption of twelve months is allowed against income for less than twelve months. Obviously, then, if any tax would be payable on a full year's income, less tax would be payable on the short-period income. It would make no difference, however, if no declared-value excess profits tax would be payable for the full twelve months. As a corollary, of course, if you know what you are going to do, a small amount of capital stock tax might be saved by declaring a lower value, in view of the contemplated short-period income.

As for the normal income tax and surtax, it makes no difference with respect to incomes over \$25,000.00 but might make a slight difference on incomes under that amount.



However, the maximum amount that could be involved in that situation is too minor to spend time discussing it.

**(2) The effect in future years of changes in the taxing statute:**

Taxpayers who had adopted fiscal years prior to the beginning of 1942 have obtained some decided advantages. It has been the practice, for some time now, to make new laws effective with taxable years beginning on or after January 1 of the year of enactment. As rates have been steadily increasing, deductions have become less liberal and so-called "loopholes" have been steadily eliminated; this lag in the application of the new tax laws has been extremely beneficial. The obvious and most readily appreciated illustration is that of the fiscal year November 30th taxpayer whose income for the eleven months ending November 30, 1940, escaped excess profits tax. Following the same principle, it may be expected that the income of that same taxpayer for the eleven months from January 1 to November 30, 1942, will fall under the old excess profits tax law, with a maximum rate of 60%, instead of the law now being developed which, so far as the House Ways and Means Committee's decision goes at the moment, will call for a 94% excess profits tax rate. Theoretically, that situation will be reversed when changing conditions result in reductions in the tax rates. However, it is not likely that rates will be reduced until the present emergency will have ended, and the cessation of war profits and war operations will make the subject of excess profits taxes more academic than real in most cases. As long as the present trend continues, there is an advantage in a fiscal year arrangement. It cannot be denied, however, that when the tables are

reversed, there may be a disadvantage but, if past experiences can be taken as a guide, the theoretical disadvantage will not be costly taxwise—there will not be excess profits in most cases. That conclusion is very likely to apply to operations that have been converted to war production. It is not likely to apply to operations that cease during the war.

**(3) The general effect of using a natural business year rather than an unnatural business year:**

The final feature to consider is the effect on future tax costs, regardless of changes in the law, of using a natural business year, or taking the long-range view during the period after our tax laws get back to what might be called "normal," whatever that is. It has been my own experience that taxpayers, who have been using the natural business year or, to state that another way, who have not been closing their accounts in the middle of the season of active business but have been closing their accounts during the so-called "dull" or "off" season, have materially benefited in recent years. Very frequently we find that good seasons usually result in greater chargeoffs, losses or deductions at the end of the business season. The net result is very good because the good business makes it possible to absorb the somewhat increased losses or chargeoffs and still leave a high net income; but if the accounts are closed during the middle of the good season when business is at its best, the closing will come before the losses or deductions are realized for tax purposes and, though they may be attributable to, and related to, that good business prior to the closing date, the reserves which good management may set up in anticipation thereof can not be deducted in figuring tax liabilities. I need not dwell on how often good business neces-

sarily results in increases in certain types of losses and deductions; but a few illustrations may suffice to bring the point home.

As one illustration, take the case of a taxpayer operating a resort hotel in Florida and let us assume that it closes its accounts on December 31st. In anticipation of what turns out to be a very good season, it expends a more than normal amount of money immediately before December 31st in repairing and furnishing the hotel, training a larger staff, and getting all ready for the good business that is in the offing. All that loss and expense is incurred prior to December 31st and prior to the time when the taxpayer realizes that good business. In its calendar-year accounting then, that would be taken as a charge against the income of the preceding season which may or may not have been good. The results of the current season are realized in the next calendar year and, if at the close of that year retrenchment in expenditures is required because a good season does not appear in the offing, the taxpayer will find that the result of the good season has not been offset by the appropriate expenses that it involved.

Another illustration is a merchandising business. If it has a good seasonal operation, it is likely to expand its inventories and commitments and may find that at the close of its season it has on hand a larger inventory on which it must take the usual chargeoff for "off" season merchandise losses due to the style factor, damage, etc.; but if it closed its accounts before that point was reached, such losses could not be taken as an offset against the profits of the good business but would fall into the following taxable year. And if the following season happens to be poor, the taxpayer will find its poor results further reduced by losses that really resulted from a

previous good season, the income from which does not fall in the same taxable year.

Clearly, it is better, from a tax point of view, to have the taxable year include the complete cycle of active business operation and necessary readjustment, deductions, and losses, at the close of the season, so that all the ensuing losses which might be inventory, declines, higher-than-normal maintenance or repair expenses, bad debts from sales in the good season that were not collected, etc., will have materialized into tax-saving deductions. By ensuring that they will offset the good season income which, without such offsets, might reach the higher excess profits tax brackets, the maximum tax saving—growing out of such losses—will be realized. On the other hand, if by reason of a non-season-end closing, such losses or expenses are left to apply against the next season's income, the taxpayer may find that there is no income. And even if the next season's income should be good as the result of another good period of operations, that will also produce its offsetting deductions and losses, when the season ends, which will be deferred to another taxable year however, so that sooner or later a bad season will catch up with the losses of the previous good season and both will fall in one taxable year.

#### **Technical requirements for changing the taxable period:**

While, of course, a taxpayer could change his accounting period for the purpose of general accounting and still continue on the old basis for income tax purposes, it is obviously desirable to effect the change for tax purposes as well. Officially, the approval of the Commissioner of Internal Revenue is required but the Commissioner generally grants that permission and does so without at-

taching any strings to his approval. To explain why that is so involves a discussion of tax technicalities which time does not permit. All the taxpayer has to do is to file a special form, No. 1128, within thirty days after the end of the proposed new taxable period. He does not have to decide in advance when he wants to close accounts on a natural

business year basis. He could wait until after that period has arrived and, if within thirty days after the end of the proposed new taxable period the appropriate form has been filed with the Commissioner of Internal Revenue, he is almost certain to be granted the right to use that basis for income tax purposes.

### Address by A. R. M. Boyle

Treasurer of Lehn & Fink Products Corporation, New York

The assignment which has been given me is to state why Lehn & Fink Products Corporation changed its fiscal year from a calendar year to one ending June 30; to point out any seasonal or accounting factors which entered into our decision; and to say how the use of the natural business year has simplified the financial reporting and related problems of the company.

We made this change in 1940. The reasons which impelled us to make it were several and they had been making themselves increasingly felt during the years that preceded it.

We are manufacturers of nationally advertised brands of consumer products sold by us chiefly to wholesale and retail druggists, department stores, 5 and 10 cent and other general merchandise chains etc. These products include disinfectants, tooth pastes, tooth powders, face, hand and body lotions, cosmetics and other toilet articles.

Many of these items are highly seasonable. For example, all lotions are used in substantially greater volume in the winter than in the summer because of their great use for chapped skin and other similar discomforts due to winter weather.

Perfumes, colognes, cosmetics and toilet articles generally are winter sellers with many special packings

and gift sets made especially for the Christmas trade. Christmas items begin moving to the trade around October and shipments continue into the Christmas week. Due to certain trade practices, net results of Christmas business are not known until January.

By far the greater portion of our business consists of items which have a greater volume during the winter months than during the summer.

These normal seasonal variations for our type of merchandise have been greatly aggravated in recent years by changes in our merchandising methods. Prior to 1931 or 1932 our main sales promotion activity consisted of national consumer advertising. So long as this condition prevailed and we simply supplied the demands which our advertising created, the flow of merchandise followed more or less a definite pattern determined by consumer purchases at the retail counters throughout the country. This pattern remained very much the same from year to year.

In the intensified competition which came as a result of the depression of the 1930's a number of merchandising devices were employed which were new, at least to us. Various forms of deals, two for one sales, half-price sales, combination offers

and other stratagems were resorted to. These were designed to stimulate the sale of a particular product to the wholesaler, retailer and consumer for a short period of time, usually a few weeks. Sales of abnormally large volume during or preceding the sale period were thus created. This was followed by sales of abnormally low volume while the merchandise which had been forced on the market was being absorbed. These special promotions are launched at such times as the sales department deems most advantageous and not always at the same time as in the previous year. So great is the effect on the sales curve that monthly comparisons with prior years become meaningless.

Shipments of such merchandise by us always precedes by a week or two the breaking date of the sale at retail. This is because distribution to the wholesalers and retailers throughout the country must be accomplished in time for all retailers to have the merchandise on the opening date of the sale.

I have in mind a series of promotions of this kind which were scheduled to break at retail the beginning of January. All of this merchandise was shipped and billed by us in December. It was not, however, legitimate December business, it was January, February and March business because these were the months when we would have sold that merchandise in the ordinary course.

On a calendar year basis either one year's profits would have been inflated by several hundred thousand dollars and the following year's profit would have suffered accordingly or else deferred income reserves in some form would have been necessary.

If these profits had been taken in the calendar year in which the shipments were made, stockholders and the public would have been grossly

deceived as to the true earning power of the business.

If, on the other hand, reserves had been provided with respect to such earnings the difficulty of determining what portion of many operating expenses and overhead had been incurred with respect to these sales would have been considerable. In an annual statement, such estimates are not desirable, and they are not necessary where the fiscal year ends at a time when such conditions do not exist.

Another large factor entering into our decision was the importance of our advertising expenditures. We spend large sums of money on this item. These are planned on an annual basis but the greatest expenditures are made during the period of greatest consumer purchases namely the fall, winter and spring. Obviously these are more properly charged to the year in which they belong when the year closes after the cycle has been completed and not right in the middle of it.

In short our business year comes to a more natural end in June than it does in December. At that time there is less room for errors of judgment or differences of opinion in all of the steps which have to be taken in determining the financial position and the earnings of the company for a twelve month period.

Then too, the two months preceding and the two months following the close of a fiscal year are ones in which a great deal of work of an accounting and financial nature is done which is not done during the remainder of the year.

Before the close of a fiscal year we are busy preparing our budget covering the next year's operations. Standard costs also are completely calculated for all our many items prior to the beginning of the new year.

After the close of the fiscal year the accounts have to be closed,

## *Problems of Financial Reporting under Wartime Conditions*

financial statements prepared and audited, tax returns and reports to the S.E.C. must be prepared and filed, etc.

We do not take a complete physical count of inventories at the end of our fiscal year since we are constantly checking physical quantities with perpetual inventory records all through the year but we do go over thoroughly the prices and values of all inventory items at the end of the fiscal period.

To undertake these once a year tasks at the time of greatest business

activity only makes difficult times more difficult. Fixing the close of the business year at the time of least business activity insures greater accuracy—more thorough consideration and infinitely less strain on all parts of the organization.

To sum up, we have adopted a fiscal year ending June 30 because that is the time when most of our products have completed their seasonal cycle. During this relatively quiet period we are better able to appraise the results of the year that has passed and prepare for the year that is to come.

### **Concluding Remarks by Saul Levy, C. P. A.**

#### **Chairman, Discussion Luncheon on "Problems of Financial Reporting under Wartime Conditions"**

As our luncheon program comes to its conclusion, I want to express to our speakers our earnest thanks for the stimulating discussion they have offered to us. They have pointed out with clarity and conviction the role which the natural business year can and should play as a wartime aid to business.

For many years the adoption of the natural business year has been diligently sponsored and urgently recommended in many quarters. The obvious advantages to the reporting company itself have been stressed as compelling reasons for getting away from the calendar year basis in most cases. The questions of where and when to start have been solved by thousands. They have given full consideration to specific seasonal fluctuations in their particular industry and so have chosen a fiscal year date. The decision when to start has usually depended upon the initiative of some executive or professional advisor who took it upon himself to bring home to the management the advantages of taking action.

As both Mr. West and Mr. Cooper have indicated, there is always a tax question involved. More often than not, however, there have been tax benefits rather than tax disadvantages. Moreover, under the existing law, the application for a change to a natural business year may be made within thirty days of the end of the new foreshortened fiscal period. This affords an opportunity to take the operating results of the short period into account before reaching a definite decision.

Public accountants have been dealing with these problems for many years and are always ready to cooperate with financial executives in reviewing the desirability of a change in any specific case as well as helping to ascertain the most logical closing date to be adopted. A great amount of data based upon the experience of others is already available as a practical aid to those contemplating a change.

The S.E.C., the New York Stock Exchange, bankers, credit grantors and public accountants have been unanimous in urging that financial

reporting based upon a natural business year produces more dependably accurate results to the advantage of all concerned. Only such reporting will present the unbroken results of a complete annual cycle, instead of a composite of fragments of two successive annual cycles. The financial position at the end of a full annual cycle is certain to be more significant to the credit grantor and the investor than a passing glimpse of the state of affairs midstream.

Not only does the conventional December 31st closing frustrate more intelligent financial reporting, but it creates an utterly unnecessary peak problem alike for the financial executive, the credit grantor and the public accountant. Even in normal times this burden seriously interferes with maximum efficiency. In these days of mounting wartime requirements and personnel shortages, the arbitrary calendar year basis becomes a

serious menace. By the same token it becomes a challenge to all of us, for it offers an obvious and ready opportunity to do something about it, now when help is needed.

In presenting the case for the natural business year to this audience, we have done so with the confident hope that many of you will be prompted to act with us in urging the immediate adoption of this expedient wherever it will serve a useful purpose. All that is required in hundreds of cases is a determination to look into the matter without delay. The logic and the soundness of the natural business year becomes most convincing when its principles are applied to the specific case. Every change which can be effected at this time will lighten the load for all of us. It will help us do a better job of financial reporting under wartime conditions.

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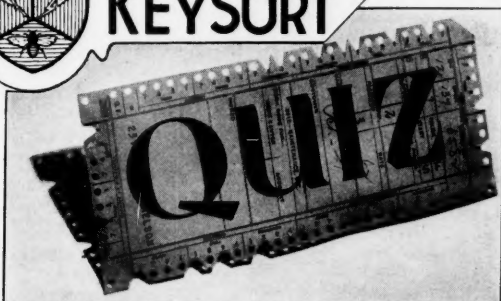
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